

The London School of Economics and Political Science

*Institutional effects: studies from the sterling area in the
1950s-60s*

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Declaration

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Abstract

The sterling area was a financial alliance of countries using sterling as their principal international reserves. Recent studies have highlighted how *external* assistance prolonged the international use of sterling in the 1950s-60s. This thesis explores the sterling area's *internal* institutional arrangements (e.g. reserve management practices and the set-up of central banks), which had complex effects on the member countries. Three case studies examine reserve developments in Australia, Ireland and the UK. Together they reveal a currency construction that supported the persistent use of sterling, but lacked stability.

The first paper presents a new account of Australia's reserve management in 1950-68, emphasising the importance of reserve pooling. Acquisition of non-sterling assets in 1951-61 was limited to gold production and undermined by Australia's balance-of-payments volatility. Diversification (substituting other assets for sterling) only began in 1962, largely through the build-up of the IMF 'gold tranche'. Diversification was gradual, hidden, and constrained by sterling area membership.

The second paper examines the development of Ireland's central bank, with its currency board arrangements, before and after the sterling devaluation of 1967. Before 1967, development was constrained, as an under-resourced central bank and independent commercial banks competed for sterling liquidity. Meanwhile government treated sterling area membership as a contract with the UK. Devaluation broke both constraints, leading to a forceful diversification, and centralisation of commercial bank reserves in the central bank in 1968-9.

The third paper applies a contemporary methodology to review sterling crises during the years 1950-67, identifying balance-of-payments flows associated with each crisis. The 'sterling balances' of the sterling area underwent significant changes in all the crises, and notable (balance-of-payments) declines in those of 1951-2, 1955 and 1957. Sterling's recurring problem was the balance of payments of the sterling area as a whole. The system's limited cohesion failed to address this, contributing to instability.

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Chapter 1. Introduction and critical discussion

Section 1: Introduction

This PhD thesis is concerned with the sterling area system, and its operational effects on its members' international reserves, during the 1950s-60s. The sterling area was a financial alliance of countries, mainly associated with the former British Empire,¹ which agreed informally to use sterling as their principal international reserve currency. Its post-war heyday was the comparatively stable period between the sterling devaluations of 1949 and 1967.² During this period, the US dollar and sterling were the only major reserve currencies.

This is a paper-based PhD thesis, incorporating three separate papers, presented as Chapters 2-4. The papers deal with different aspects of the sterling area system (central bank reserve management, the widening of central bank powers, and sterling crises) and different countries within it (Australia, Ireland and the UK respectively). In a paper-based thesis, the connections between and issues arising from the three papers are discussed through an introduction and critical review (presented here as Chapter 1) and a conclusion (Chapter 5).

Sterling area countries, defined by UK exchange controls applying from 1939 to 1972, constituted the major part of sterling's use as an international currency.³ Much has been written about the UK's policy perspectives on the sterling area, and about sterling's wider role in the international monetary system. Less attention has been given to the policies of leading independent sterling area (ISA) countries. This dissertation considers their role.

¹ Canada was the principal exception, having decided not to join the 1930s sterling bloc (Sargent, 'Britain')

² In Sep/1949, sterling was devalued from US\$4.03 to US\$2.80; in Nov/1967, from US\$2.80 to US\$2.40

³ See Schenk, *The decline*, and *Britain*, for background

Independent countries are the key to understanding the sterling area system. Without them, sterling would have been only a managed colonial reserve currency, ending with decolonisation.⁴ With them, sterling continued as a global international currency. Why did these countries persist in holding sterling? In what ways did they co-operate with the UK in reserve management? What was their role in the stability of sterling?

As a voluntary currency system, the sterling area gives the appearance of being a precedent when considering international economic institutions and international finance problems today. Stability and persistence are issues that are posed about the US dollar's international reserve role. Alliances and controls are mooted features of the potential expansion of the renminbi. Stability and cohesion are uncertainties overhanging the European Union (EU) and the Eurozone. Sterling's past international role and the UK's historic focus on sterling area relationships also contributed to, and arguably still influence, Britain's awkward relationship with Europe and concerns about European currency arrangements.

Sterling's persistence as an international currency during this period is something of a puzzle. Sterling was subject to more than a few bouts of weakness during the 1950s-60s, and the US dollar seemed to have superior attractions for much of the period. An aim is to improve understanding about why and how sterling was used in ISA countries, encompassing both sterling's reserve role (held by central authorities) and its commercial role (used by private agents).

In order fully to understand sterling in the 1950s-60s, three constituencies must be addressed: the UK itself, the rest of the sterling area (RSA) and all other countries and multilateral institutions that comprised the non-sterling area (NSA). This is a vast policy

⁴ British colonies had less reserve management freedom

landscape when considered over two decades. The leading economic historian of sterling and the sterling area for this period, Professor Catherine Schenk, has tackled much of it, particularly from the perspective of UK policy,⁵ and the support provided to sterling by the NSA (e.g. from the USA, OECD, IMF or BIS). Schenk argued that the UK and major countries and organisations in the NSA had a common interest in preserving sterling's international role for the sake of the international monetary system.⁶

External support and a generalised common interest do not, however, fully explain divergent behaviours towards sterling by the RSA and NSA groups, broadly understood and also evident in this thesis. The RSA's greater persistence with sterling suggests the need for additional analysis of leading countries within the independent sterling area. Discovering the RSA/ISA perspective on reserve management is challenging. Eichengreen reasoned that ISA countries, holding more sterling than seemed justified by economic fundamentals, must have been motivated by loyalty to the UK.⁷ However, the well-informed UK Treasury historian of the 'sterling balances' argued that it was 'impossible to summarise' RSA countries' policies since each RSA country had its own reasons for being part of the sterling area, and for sticking with it or not.⁸ It is noticeable that, at various points, some countries left the area (e.g. Egypt, Iraq, Southern Rhodesia, Burma), while others (e.g. South Africa) gradually disengaged although remaining within the area.

RSA countries' perspective can thus only be revealed by investigating the relevant government and central bank archives in some qualitative depth. Access can be an issue, particularly for central bank archives, which are essential for the analysis.

⁵ Schenk, *Britain, and The decline*

⁶ Schenk, *The decline*

⁷ Eichengreen, *Global imbalances*, p134

⁸ TNA:T267/29, 'Sterling balances since the war', Symons, 1972, p59. The sterling balances were net liquid external liabilities of the UK in sterling, see idem and Schenk, *Britain*

Schenk has made a close study of reserve management in Hong Kong, Malaysia and Singapore.⁹ There has also been an analysis of Australia and New Zealand (a slightly later period),¹⁰ and more tangential studies of Ghana, Nigeria¹¹ and South Africa.¹² But these were only first forays, and in other areas, Ireland, the Indian region,¹³ the West Indies, Kuwait¹⁴ and the Middle East, other parts of Africa, reserve management analysis focused on the use of sterling in this period has not yet been undertaken.

What conclusions have been drawn from these few country case studies? Broadly, Schenk and others have found that RSA countries held sterling for rationally self-interested reasons. Although the transactional reasons for holding sterling weakened as trading relationships widened, RSA countries persisted with sterling because, like the leading NSA countries and organisations, they had a collective interest in preserving its value. For large holders such as Malaysia and Australia, it was hard to dispose of their sterling reserves without adverse repercussions.¹⁵ Schenk described these collective interests as ‘network externalities’.¹⁶

A principal aim of the PhD is to build on Schenk’s work and to fill gaps in understanding of RSA countries’ reserve management. I also believe that the wider literature about sterling’s history requires adjustment in certain areas. In general, writings about sterling have tended to underestimate or oversimplify the role and importance (both for the UK and internationally) of the sterling area during this period.

⁹ Schenk, ‘The empire strikes’; ‘The evolution’; ‘Malaysia’; ‘The dissolution’

¹⁰ Singleton and Schenk, ‘The shift’

¹¹ Schenk, ‘Monetary institutions’ for Malaya, Ghana and Nigeria; Stockwell, ‘Instilling’ for Ghana

¹² Henshaw, ‘Britain, South Africa’

¹³ There is a study of India-UK sterling negotiations, but this relates principally to the 1940s (De P. Abreu, ‘Britain as a debtor’)

¹⁴ Smith discussed Kuwait’s entry into the sterling area, but not reserve management (Smith, “A vulnerable point”)

¹⁵ Singleton and Schenk, ‘The shift’; Schenk, ‘Malaysia’

¹⁶ Schenk, *The decline*, p89. Schenk’s focus on network externalities contrasts with an earlier literature, which portrayed RSA behaviours as bilaterally ‘negotiated’ with the UK, and involving costly UK concessions (Strange, *Sterling*)

Firstly, sterling's slow decline as a reserve currency in the twentieth century is sometimes invoked by commentators to provide lessons for the current day, when arguing for the persistence of the dollar as the dominant international currency.¹⁷ But such comparisons can neglect the importance of the sterling area's historical context of rules and controls, which placed self-imposed constraints on RSA countries and limited the role of private agents.¹⁸ Secondly, the sterling area is sometimes proposed as a co-operative financial system, bearing favourable comparison with other historical co-operative arrangements.¹⁹ But the nature of its co-operation has not been well-defined. Sterling area countries co-operated together financially closely in some ways, barely in others. The mechanisms of the sterling area system need to be better understood. Thirdly, it has been proposed that the sterling area lost its significance after the achievement of sterling convertibility in the mid- to late-1950s, so that by the 1960s the sterling area relationships had become irrelevant.²⁰ This is not true, as the case studies herein show. Fourthly, the 1950s-60s saw frequent sterling crises. These crises have largely been attributed to UK balance-of-payments problems and speculative capital movements in developed financial markets.²¹ A broad investigation of the role of the sterling area in these crises has not been undertaken.

Two of the three papers are primarily central bank case studies, addressing Australia (an earlier and longer time period than has been previously covered) and Ireland (a new country investigation) respectively. The third paper applies contemporary methodology to investigate the role of the whole sterling area in sterling crises of this period.

¹⁷ Helleiner highlighted the slow decline of sterling from the 1960s as a lesson for the dollar (Helleiner, *The status quo*)

¹⁸ These aspects were, however, emphasised in Schenk, *Britain*

¹⁹ Cooper, 'Almost a century', p86

²⁰ Robertson and Singleton, 'The Commonwealth', p265; Singleton and Robertson, *Economic relations*, p3

²¹ For the literature, see the sterling crises paper

As already noted, we should be wary of generalising from sterling area case studies to the sterling area as a whole. Even so, case studies can help our understanding of the sterling area, which consisted of unequal players. By the second half of the 1960s, Ireland was among the top five holders of sterling, five countries which collectively held around half the area's sterling reserves.²² Australia held that top five position throughout the period, and was arguably the most important and influential sterling area country outside the UK. If the sterling area is a puzzle to be completed by historians, these countries were two of the biggest pieces on the table. They also have significant, accessible archives and by the mid-1960s they were far more committed to sterling than, say, India or South Africa.

The Australia case focuses on central bank and government policies, since in Australia all gold and foreign exchange ('FX'), including sterling, was mobilised into the central bank throughout the period. The story emerging from the literature was about a country gradually distancing itself from sterling from the early 1950s by diversifying in line with trade and capital flows. Australia still maintained significant sterling holdings for voluntary transactional and prudential reasons by the late 1960s.

However, the new collected evidence provides little support to the traditional story on Australia, since this country did not distance itself from the sterling area until very late. Apart from a significant decision in 1951 to retain its gold production, which was in fact a reversion to pre-1947 policy, Australia did not take any deliberate steps to diversify from sterling until 1962, after the UK applied for membership of the EEC. Rather, its diversification appears to have been blown off the policy path taken by that 1951 decision, with some major purchases of sterling for gold and dollars in 1952-61. From 1965, when its policymakers became very concerned about sterling's prospects, the

²² Australia, Hong Kong, Ireland, Kuwait and Malaysia (Strange, *Sterling*, p89; BOE:EID1A129/2-4)

Australian central bank largely continued to follow the sterling area 'reserve-pooling'²³ rules. The diversification was discreet, for instance by encouraging the build-up of Australia's 'gold tranche' at the IMF, and occasionally not converting dollar receipts into sterling. Australia's reserve management in the 1950s-60s, although rational and deliberate, appears to have been significantly influenced by Australia's membership of and commitment to the sterling area. The paper explains the ways in which this occurred.

The Ireland case study describes the transition of the country's young central bank from a 'virtual' currency board towards a more independent institution. The Central Bank of Ireland was able to diversify its reserve holdings dramatically away from sterling, despite remaining in a 'virtual' monetary union with the UK (continuously pegging its currency to sterling on a no-margins one-for-one convertible basis), and notwithstanding the dominant share of the UK in Ireland's trade. Ireland is also interesting because of its private holdings of sterling, and the commercial banks' use of this currency as liquid banking reserves. Notional central bank powers to widen reserve assets beyond sterling and gold were taken from the 1950s, but diversification really began only in 1968.

The sudden Irish diversification of 1968 was a political decision and not only a direct response to the 1967 sterling devaluation. Until then, Ireland's reserve management had been constrained by the 'tripartite' institutional set-up of its banking system and the relative weakness of its central bank. The full desired programme of diversification could only be completed after centralising commercial banks' sterling holdings in the central bank. This was achieved in 1968-9 as part of a far-reaching package of policy and legislative measures (1968-72) which conferred more power on the Irish central bank. As for Australia, then, the institutional set-up of the 'sterling link' at first

²³ Reserve pooling and sterling area rules are discussed later in this chapter

constrained the central bank in the 1950s-60s. However, institutional change allowed the central bank to break these constraints, despite the continuation of the sterling link.

The third paper is a period piece. Engaging with debates of the time about the causes of sterling crises, it applies a contemporary methodology to explore the sterling area's role in sterling crises of the years 1950-67 (ending with the 1967 devaluation). The contemporary economist Richard Kahn issued two full reports on the sterling crises of 1964-8.²⁴ A simplified version of his balance-of-payments accounting approach is used to track movements in the wider sterling area's sterling holdings, against movements in the UK's international reserves (after taking account of international assistance from the NSA), during the major reserve downturns after 1950. The sterling area's sterling holdings declined significantly during the crises of 1951-2, 1955, 1956, 1957 and 1964, and would have declined in the 1961 crisis, but for an IMF drawing by Australia. These declines in RSA sterling holdings were principally driven by the fundamental balance of payments of the RSA, rather than by loss of confidence in sterling (although there was a sizeable confidence movement in 1964). The declines of 1951-2, 1955 and 1957 are notable because, according to Kahn's framework, they appear larger than other contributory factors behind the loss of reserves. There are, however, certain critiques that could be made about this contemporary analysis, as the paper sets out.

The methodology and sources of each paper vary, as discussed in the three papers. But each relies on qualitative and deep engagement with new archival information, particularly from the relevant central banks (Australia, Ireland and the UK respectively). Using this data, each paper finds patterns of behaviour which have not been addressed in the literature, and so together they clarify our understanding of the sterling area, and broaden knowledge about topics such as central bank evolution and reserve management.

²⁴ For references, see the paper

In summary, as exemplified by Australia and Ireland, the persistence of sterling as a world currency derived not from pure economic externalities but also from institutional factors – the implied rules and institutional inheritance of sterling area membership – combined with an economic and political calculus that sterling area membership was beneficial for the country concerned, and an element of trust that the UK would act to defend the pound's value. The cohesion of the sterling area was largely limited to consultation, reserve pooling and the design of exchange controls (the rules of sterling area membership), none of which were perfect or addressed the fundamental payments imbalance with the wider world of the whole sterling area (UK plus RSA). This fundamental imbalance lay behind the instability of sterling.

These findings re-emphasise the institutional foundations of the sterling area system, which has in recent times largely been analysed in terms of the transactional and risk-optimising drivers highlighted by the economic theory of reserve currencies. The sterling area was an inter-governmental arrangement, and the commercial role of sterling, both within and outside the sterling area, was largely influenced by national exchange controls and the use of sterling as a reserve currency by RSA countries. The thesis thus confirms and builds on Schenk's early arguments about the institutional foundations of the RSA's sterling reserves.²⁵ Summative conclusions and original findings from the three papers are brought together in Chapter 5.

This introductory chapter links the three core papers and proceeds as follows. Section 2 engages critically with the literature regarding reserve currencies, monetary rules and institutions, and monetary co-operation and co-ordination. Section 3 provides a critical review of the literature on the sterling area, with a special focus on its monetary

²⁵ Schenk, *Britain*, pp20-7

and exchange rate arrangements. Section 4 summarises the motivations of the thesis and defines the research questions to be explored in Chapters 2-4.

Section 2: Reserve currencies and monetary institutions – critical discussion of the literature

This Section addresses economic determinants of international currencies and reserve composition; monetary rules and institutions; and monetary co-operation.

2.1 Economic determinants of international currencies and reserve composition

Government organisations and private agents hold international reserves for a variety of reasons. Collectively, these demand factors, combined with supply factors (namely, the attributes of issuers of reserve currencies, including the willingness of these countries for their currencies to be so used) explain the size and composition of international reserves in the world.

2.1.1 Economic determinants – supply factors

Let us start with the supply factors. Firstly, there are the benefits of issuing an international currency, with two sets of economic benefits being commonly described. The first are seigniorage revenues, the net profits derived by a central bank from issuing currency. The second arise from increased activity (and profits) in the domestic financial markets of the issuing country.²⁶

Economists argue that there are additional benefits. An international currency can grant the issuing country the 'exorbitant privilege'²⁷ of running balance-of-payments deficits without the need for policy adjustment. Instead, foreign countries can either finance these deficits, delaying adjustment, or adjust their own policies by expanding to accommodate the issuing country's policies. Implicit in this 'instrumental' benefit is an

²⁶ De Grauwe, *Economics*, pp71-2. For sterling, see Cohen, *The future*

²⁷ Eichengreen, *Exorbitant privilege*

economic bargain between the issuing country and the countries providing financing or policy accommodation.²⁸ A related idea is the strategic benefits enjoyed by the issuing country's corporations and banks in their international operations.²⁹

Another recent economic argument is that 'the residents of the issuing country experience an increase in the purchasing power of their currency both at home and abroad', with these benefits far exceeding those of seigniorage.³⁰ Under this theoretical approach, the expansion of international currency has terms-of-trade benefits for the issuer, reducing domestic inflation and increasing the exchange rate. (The logical corollary is that, if the process is put into reverse, there is an opposite economic effect: increasing domestic inflation and putting downward pressure on the exchange rate).

A final set of benefits, more political than economic, fall under the headline of 'structural power' or 'geopolitics'. An international currency provides the issuer with economic weapons, and converts foreign users of the currency into exposed stakeholders. Together these agenda-setting and shared-interest advantages help an issuing country to pursue geopolitical goals.³¹ Kirshner categorised such weapons of 'monetary dependence' into four types: enforcement, expulsion, extraction and entrapment.³² On the other hand, it has been argued, such benefits on the upside produce additional burdens on the downside, for an international currency in decline. Referencing sterling's decline from the 1960s, Kirshner highlighted the monetary 'overhang' of international reserves that must be absorbed, creating 'chronic monetary pressure',³³ and the loss of prestige and credibility, with the result that, with increased international concern, external discipline is swift and 'the long leash is replaced by an

²⁸ Helleiner and Kirshner, 'The future', pp12-14

²⁹ Helleiner and Kirshner, 'The future', pp5-6

³⁰ Kannan, 'On the welfare': the quotation from p1

³¹ Helleiner and Kirshner, 'The future', pp15-17; Kirshner, 'After the (relative) fall', pp204-10

³² Kirshner, *Currency and coercion*

³³ Kirshner, 'After the (relative) fall', p209

exceptionally tight choker'.³⁴ It seems that the fear of inflation and loss of monetary control deterred West Germany from allowing its currency to become internationally used in the 1950s-60s, while Japan prevented the yen's wider use in order to protect its industrial strategy.³⁵

Secondly, on the supply side, there are the fundamental economic attributes which reserve currencies possess. There is broad consensus about these. Lim, considering the prospects of the dollar and euro, described five 'facilitating factors' of a reserve currency issuer on which economists agree: large economic size, a well-developed financial system, confidence in the currency's value, political stability and 'network externalities'. Network externalities arise because the general use of particular reserve currencies encourages their wider use through positive feedback effects in demand and efficiencies in supply. Incumbent reserve currencies also have an advantage through sunk costs and lock-in arrangements, leading to inertia. Debates between economists about the prospects for the dollar and the euro have reflected different weights being attached to the five factors.³⁶

Applying this framework to the 1950s-60s, however, suggests only one plausible economic reason for sterling's persistence relative to the dollar as a reserve currency. On economic size, financial system, confidence and political stability, the dollar seemingly had the edge over sterling in this period. Conventional network externalities are also supposed to favour the dominant reserve currency, once a 'tipping point' has been passed, and in reserve currency use the dollar had clearly overtaken sterling by

³⁴ Kirshner, 'After the (relative) fall', p210

³⁵ Eichengreen, Chitu and Mehl, 'Stability or upheaval?', p373

³⁶ Lim, 'The euro's challenge'. Helleiner and Kirshner similarly listed the 'market-based' factors behind international currencies as confidence, liquidity and transactional networks. In their scheme, confidence also encompassed political stability, liquidity stood for the financial system, while transactional networks merged size and network externalities (Helleiner and Kirshner, 'The future', pp7-11). See also Eichengreen, Chitu and Mehl, 'Stability or upheaval?', which considers inertia, policy credibility and network effects

the mid-1950s.³⁷ Almost by default, among economists, inertia is commonly taken to be the reason for sterling's slow decline.³⁸

There is a debate about the role of inertia. Chinn and Frankel, looking at the late twentieth century, found inertia, and the non-linear pattern of network externalities implied by a tipping point, to be significant empirical features of reserve currencies.³⁹ But Eichengreen and Flandreau, considering the inter-war period, in which the share of the dollar and sterling in reserve currencies fluctuated, cast doubt on inertia, incumbency and network effects.⁴⁰ They attributed sterling's resurgence in the 1930s to the politics of the sterling area countries, which tended to hold sterling to the exclusion of other currencies.⁴¹ Eichengreen was particularly doubtful about the power of network externalities and inertia over international currencies, arguing that they may influence the use of a key currency as a means of exchange, but not so much as a store of value, where it is confidence, stability and expected returns that matter.⁴² In any event, inertial forces are being weakened by financial innovation and technology.⁴³

According to an article by Eichengreen, Chitu and Mehl, using aggregate reserve data from 1948, the drivers of different key currency holdings may have changed as the Bretton Woods system transitioned around 1973⁴⁴ into a world of floating exchange rates – in a new view ascribing greater importance to liquidity, dealing costs, exchange controls and other institutional factors. During this transition, inertia and policy credibility became more influential while network effects became less so. On the one hand, the increase in inertia's role meant that the 'upheaval hypothesis' (under which it

³⁷ Schenk, *The decline*, pp22-3; Eichengreen, Chitu and Mehl, 'Strategy or upheaval?', p359. In bond markets, the dollar overtook sterling in 1929 (Chitu, Eichengreen and Mehl, 'When did')

³⁸ Krugman, 'The international role'; Bergsten, 'The euro'

³⁹ Chinn and Frankel, 'Will the euro'

⁴⁰ Eichengreen and Flandreau, 'The rise and fall'

⁴¹ Eichengreen and Flandreau, 'The rise and fall', p403

⁴² Eichengreen, *Global imbalances*, pp129-30

⁴³ Eichengreen, *Global imbalances*, pp144-5

⁴⁴ Their paper also showed structural breaks in 1960 (when confidence questions began to be raised about the dollar) and in 1966 (when sterling's weakness was perhaps already anticipating the demise of Bretton Woods)

was thought the move to floating would cause central banks to hold less reserves and diversify away from the dollar) was not fulfilled: the dollar remained the dominant currency. Inertia in the Bretton Woods period was less important, because of the decline of sterling and the rise of the dollar in this period. The sterling area was constrained from diversifying into other currencies by political ties, and the UK had in place strong monitoring and enforcement technologies such as exchange controls, but gradually sterling's reversal took place under Bretton Woods. On the other hand, the authors argued, the decline in the role of network effects after Bretton Woods reflected a reduction in switching costs as financial markets offered more liquidity. They also found that policy measures to promote or protect the take-up of key currencies were generally ineffective, while policies to restrict a currency's international use were more successful.⁴⁵

Engaging principally with the economic debate about inertia, and economists' reserve currency models, Schenk sought to identify the inertia affecting sterling's reserve currency use in the post-war period. In contrast to an earlier literature which had stressed the UK's geopolitical ambitions and pursuit of prestige,⁴⁶ the answer was 'institutional support mechanisms, which delayed the tipping point for the pound'.⁴⁷ More specifically, 'sterling's role was prolonged by the structure of the international monetary system and by collective global interest in its continuation'.⁴⁸

2.1.2 Economic determinants – demand factors

With its focus on ISA countries and central bank case studies, this thesis takes particular interest in the demand-side perspective of the individual central bank, which is distinct from the supply-side aspects or the global aggregates. The attention is also

⁴⁵ Eichengreen, Chitu and Mehl, 'Stability or upheaval?'

⁴⁶ Strange, *Sterling*

⁴⁷ Schenk, *The decline*, p29

⁴⁸ Schenk, *The decline*, p30

on developing countries, which formed the bulk of the RSA. (While not low-income countries, Australia and Ireland were both agricultural exporters prioritising development). On this demand side of the economic literature, the principal decision variables are the size and currency composition of reserves, and, across that currency composition, the portfolio of assets to be held. The primary focus here is on the currency composition, but these aspects are inter-linked, and it is instructive to begin with the general appetite for reserves.

Studies of the demand for reserves take as their starting point the functions of money and the reasons for holding it. A common typology references the use, by private agents and official holders, of international money as a medium of exchange, unit of account and store of value. This is set out in Table 1:

	Functions of money		
Levels of analysis:	Medium of exchange	Unit of account	Store of value
Private	Vehicle currency (foreign exchange trading), trade settlement	Trade invoicing	Investment currency
Official	Intervention currency	Exchange rate anchor	Reserve currency

Table 1: Roles of an international currency

Source: The table is taken from Cohen and Benney, 'What does', Table 1, p1020. There is a similar table in Chinn, 'Emerging market economies', p157, which cites Kenen, 'The role', as the original source; and in Krugman, 'The international role', likewise referencing Cohen, *The future*. A similar table appears as Table 1.1 in Schenk, *The decline*, p2, and is also described in words in Helleiner and Kirshner, 'The future', pp3-4

For example, the vehicle currency role means that the US dollar, for market efficiency reasons, is today used predominantly as the currency against which other currencies are traded in the FX market. Similarly, central banks use a particular international currency or currencies for intervention purposes, in order to stabilise or influence the external value of the domestic currency. Different functions require different attributes (e.g. liquidity and widespread acceptability for a medium of exchange, stability for a unit of account, and confidence, long-term stability and expected returns for a store of value).

The demand for reserves, following theories of the demand for money, is often divided into transactions, precautionary and speculative motives. Heller's seminal work on optimal reserves argued that private agents occupy the transactions (for trade) and speculative (for investment) space, while within central banks, which do not trade and should not speculate, demand for reserves is precautionary.⁴⁹ Since reserves finance balance-of-payments deficits, precautionary reserve management is a policy alternative to other policies, such as economic adjustment or external financing,⁵⁰ which must together form a coherent economic strategy i.e. incorporating 'macroeconomic policies, exchange rate regimes, financial sector soundness, and debt management'.⁵¹ Heller's model recognised these trade-offs by optimising reserves in the context of the income cost of adjusting to an external imbalance (a function of trade openness, proxied by the ratio of imports to GNP), the opportunity cost of holding reserves (the difference between the social return on capital and the yield on liquid reserves), and the volatility of reserves. Heller estimated empirically the optimal reserves of a range of countries in 1963, finding actual reserves more than adequate in most developed countries (albeit not the UK) but mainly insufficient in the primary-producing regions of Latin America, Asia and Oceania.⁵² Although mindful of the model's limitations (it did not address the greater needs of reserve currency issuers and was focused on small countries), Heller concluded that the optimal reserves framework was superior analytically to the prevailing reserves/imports rule-of-thumb measure of reserve adequacy.⁵³

Heller's model prompted further work on optimal reserves. A 'buffer stock' approach hypothesised that reserves followed an inventory model. They would decline from their

⁴⁹ Heller, 'Optimal international reserves', pp300-4

⁵⁰ Bird and Rajan, 'Too much?', p876

⁵¹ Bird and Rajan, 'Too much?', p888 (citing an address at the IMF by Fischer in 2001)

⁵² The actual/optimal reserves ratio calculated by Heller included sterling area examples: Australia 0.97; Ghana 0.60; India 0.48; Ireland 2.67; Malaysia 3.95; UK 0.83

⁵³ Heller, 'Optimal international reserves'

optimal level until they reached a minimum at which adjustment would be actioned in order to restore them to their optimal level.⁵⁴ While Heller saw openness as lowering the income cost of adjustment, the buffer stock model regarded openness as increasing income fluctuations, by increasing exposure to international shocks. Another optimal reserves model took the exhaustion of reserves to be much more costly than mere policy adjustment: it was really the cost of default, which could have a devastating cumulative income effect on a country, a multiple of one year's GNP. Estimating a cost-of-default function and applying it to Israel in the 1970s, the model seemed to explain actual reserves more closely than the other versions.⁵⁵

Although there has been an extensive literature on the holding of international reserves,⁵⁶ and the range of relevant factors could be identified (e.g. 'openness, vulnerability to shocks, the nature of the exchange regime and the response of the relevant monetary authorities to uncertainty'),⁵⁷ Bird and Rajan argued that the optimising model foundered on the difficulty of implementing it empirically with precision.⁵⁸ Consequently, there is still great reliance on rules of thumb. Since the capital account crises of the 1990s, for developing countries these rules of thumb are now focused more on the potential capital flight of external investors (hence a view that reserves should exceed external debt with a maturity of less than one year) as well as of domestic holders of wider money, including deposits (hence reserves/M2 is another common yardstick). However, reserve management still needs to take into account the opportunity cost of holding reserves, suggesting a greater potential role for contingent financing arrangements, allowing owned reserves to be reduced.⁵⁹ As emerging countries' central bank reserves have mushroomed since the first big capital account crises, economists have sought anew to diagnose empirically the motivations behind

⁵⁴ Frenkel and Jovanovic, 'Optimal international reserves'. For review of the 'buffer stock' model, Flood et al, 'Holding international reserves'

⁵⁵ Ben-Bassat and Gottlieb, 'Optimal international reserves'

⁵⁶ Soesanto, Selvanathan and Selvanathan, 'Analysis', p82

⁵⁷ Bird and Rajan, 'Too much?', p878

⁵⁸ Bird and Rajan, 'Too much?', p878

⁵⁹ Bird and Rajan, 'Too much?'

countries' holding of reserves. Three key motivations have been identified in this recent literature – transactional (related to trade fluctuations),⁶⁰ precautionary (a response to the uncertainty, scale and speed of capital movements) and mercantilist (in which the reserves accumulated arise from an artificially low exchange rate adopted in pursuit of other objectives, consequently this excess of reserves is held for the future and not invested domestically to provide a social return).⁶¹

The end of fixed exchange rates, as the Bretton Woods system collapsed in 1973, prompted academic interest in the composition of foreign exchange reserves (or COFER). Out of these studies, two dominant theories of the determinants of currency composition have emerged: the mean-variance theory, an optimising portfolio approach focusing on expected currency risks and returns; and the transaction theory, which argues that currencies held reflect the currencies used in 'the financing of foreign trade, the settlement of foreign debt obligations and the purchases and sales of FX'.⁶²

Both theoretical ideas were addressed in a 1978 study, by Heller and Knight, which named as relevant motivational drivers for central bank reserves: safety, liquidity, risk aversion, yield, and political and institutional factors, particularly international monetary arrangements.⁶³ The authors argued that central banks were highly risk-averse and addressed policies towards wider societal goals. An efficient risk-minimising approach was for the currencies held to match those used for anchoring/pegging or intervention (which itself tended to follow currency peg arrangements). They hypothesised that currencies held by central banks would reflect a country's relevant exchange rate arrangements and trade orientation, and found empirical support for both elements in

⁶⁰ This 'transactional' need is precautionary by Heller's definition

⁶¹ For the precautionary and mercantilist drivers of aggregate reserves, see Aizenman and Lee, 'International reserves'; for a literature review, Aizenman and Pinto, 'Managing'

⁶² Soesmanto, Selvanathan and Selvanathan, 'Analysis', pp83-4. The citation is p84

⁶³ Heller and Knight, 'Reserve-currency preferences', p1

the 1970s data.⁶⁴ This, then, was the first articulation of the transactions view, which gave prominence to the currency peg.⁶⁵

Empirical studies of COFER have been hampered by lack of access to data, since individual country holdings are usually treated as confidential.⁶⁶ The leading studies of the transactions view have enjoyed privileged access to confidential IMF COFER data: Dooley, Lizondo and Mathieson (DLM), covering 1976-85, and Eichengreen and Mathieson, updating the DLM analysis for 1979-96.⁶⁷ DLM addressed the mean-variance optimising theory but their optimising model was rationally applied to the *net* foreign asset position of a country (reserve assets less foreign liabilities in each currency).⁶⁸ The conclusion was that this net asset solution was independent of the transaction costs involved in converting currencies or replenishing reserves, which were however key determinants of the gross asset (reserves) position. DLM tested the transactions influences on gross reserves empirically and found evidence that, among developing countries, COFER was determined particularly by currency pegging arrangements, and also trade flows (the volume of imports and exports traded with key currency countries) and debt service payments (the amounts denominated in the key currencies). Eichengreen and Mathieson's work broadly confirmed these results, and highlighted the remarkable stability of COFER and these transaction demand relationships over time. Overall, then, central banks seek to avoid unnecessary exchange transactions in their gross reserve management.

⁶⁴ Heller and Knight, 'Reserve-currency preferences'

⁶⁵ Nevertheless the four countries which consistently pegged to sterling in this period saw their sterling share of reserves decline from 72% in 1970 to 22% in 1976 (calculated from Heller and Knight, 'Reserve-currency preferences', p7, Table 4)

⁶⁶ For data sources, see Wooldridge, 'Changing composition', pp26-9

⁶⁷ Dooley, Lizondo and Mathieson, 'Currency composition'; Eichengreen and Mathieson, 'Currency composition'

⁶⁸ This followed earlier arguments of Dooley, who raised problems with the mean-variance approach when applied to gross reserves – principally that optimisation needed to encompass net assets and other non-balance sheet aspects. He found that, in 1974-9, COFER (gross reserves) was not highly correlated with the composition of net assets. Also the typical net asset composition differed greatly by country sub-groups (divided by income and export type). He also speculated that the eurocurrency credit markets were making it easier to adjust currency liabilities in order to optimise the net position (Dooley, 'An analysis')

By contrast, the mean-variance theorists have focused on expected returns and risk in portfolio management, reasoning that central banks will wish to diversify their holdings in order to reduce risk, and to maximise profits like other investors. The optimising approach involves, first, establishing an efficiency frontier of feasible portfolios along which expected returns are maximised for given levels of risk; and then selecting the risk-return combination on the frontier which maximises the investor's utility. Expected risk of a given portfolio is derived from the variances and covariances of assets' past returns. Key questions here are those of measurement – e.g. how are expected returns to be estimated, and in what units is risk to be expressed? Ben-Bassat hypothesised that central banks had perfect foresight (expected returns from different currencies were equal to their actual ex-post returns) and that risk is measured against a country's import basket (the currencies of the countries from which it imports) since the purpose of reserves is to pay for imports. Looking at Israel in 1972-6, he found that a low-risk optimal portfolio calculated in this manner closely matched Israel's actual currency portfolio. A similar finding was made for developing and semi-industrial countries in this period, using Heller and Knight's data.⁶⁹ Examining the Korean central bank's portfolio in 1980-7, and now using valuable information about the currency (not simply the country source) of imports, Dellas and Chin similarly found support for the mean-variance theory, whether assuming that expected returns reflected perfect foresight, or that they followed a random walk.⁷⁰

In recent times, economists have used these two competing theories to address questions about the likelihood of diversification away from the dollar. The changes in reserve composition during 1978-2006 were summarised by Wooldridge. While US dollars, Treasury securities and (especially for developing countries) bank deposits continued to dominate central bank reserves, there were significant changes. Gold's share steadily declined. Maturities of government securities were lengthened and there

⁶⁹ Ben-Bassat, 'The optimal composition'

⁷⁰ Dellas and Chin, 'Reserve currency preferences'

was credit diversification in securities portfolios, particularly into US agencies and higher-quality asset-backed securities. Aggregate currency shares were affected variously by exchange rate changes, a portfolio switch into the euro, and the compositional effect of hugely increased reserve holdings by dollar-pegging developing countries. Wooldridge predicted that diversification away from the dollar might proceed more rapidly than in the past. Active diversifiers are obscured by the aggregate numbers, and some diversification is hidden in the growing use of sovereign investment funds. Excess reserves increase the profit motive and desire to diversify, while lower transaction costs in the euro have reduced the constraints on diversification.⁷¹ Nevertheless academic studies reflecting on these major euro, liquidity and excess reserve developments have generally continued to highlight the importance of the currency peg/intervention currency in reserve portfolios, as shown by the examples below.

Papaioannou, Portes and Siourounis reasoned that a representative central bank in 1995-2005 would adopt a (low-risk) mean-variance approach – not if its reserves were low, in which case the intervention currency would dominate, but if its reserves were of a reasonable size. They also built transaction costs, together with debt, trade and pegging constraints, into their optimising model. The best fit to actual portfolios derived from assumptions that currencies would enjoy equal returns, tempered by transaction constraints (currency reserve shares at least half the level of debt or trade shares) and by costs of rebalancing the portfolio to meet transaction needs. The biggest influence on reserves was the currency peg/effective reference currency. By making the central bank's domestic currency the reference, pegging arrangements were recognised by the model and found to have large effects on optimal portfolios – for instance when Russia's dollar peg broke down in 1999.⁷²

⁷¹ Wooldridge, 'Changing composition'

⁷² Papaioannou, Portes and Siourounis, 'Optimal currency shares'

Ito, McCauley and Chan also stressed the significance of (and historical evidence for) a domestic currency numeraire for the central bank, whereby currency reserves strongly reflected currency pegs.⁷³ They investigated, for 25 countries in 2010-13, the relative contribution to COFER of dollar invoicing of exports and domestic currency co-movement with the dollar (called dollar weight in their article – in effect a behavioural currency anchor rather than a formal peg). Both variables, together with the dollar's share in FX trading, exhibited a strong contribution to COFER. Analysis of six central and east European central banks over 1997-2013 suggested an important initiating role for trade invoicing, changes in which led sometimes dramatic changes in the dollar or euro weight of these countries, which in turn altered the dollar and euro shares in reserves. The authors concluded that significant growth in renminbi invoicing could lead, through changed currency management, to a relatively rapid take-up of renminbi in central bank reserves.⁷⁴

Along the same lines, the Australian central bank is unlikely to diversify majorly away from the dollar, so long as the dollar continues to play a large role in its debt service and intervention activities, according to Soesmanto, Selvanathan and Selvanathan. The authors argued that the central bank is a conservative investor, focused on policy and operational matters, and emphasising liquidity and capital preservation. Testing transactions influences in 2000-12, they confirmed significant roles in COFER for (1) the currency share of debt service, (2) the share of exports to a reserve currency country (a negative relationship as such currencies are earned through exports), and (3) the currency share of FX intervention.⁷⁵

⁷³ When the Hong Kong currency board switched from a sterling to a dollar peg, it introduced dollars into its reserves; and similar observations for other sterling area countries (Ito, McCauley and Chan, 'Currency composition', p18)

⁷⁴ Ito, McCauley and Chan, 'Currency composition'

⁷⁵ Soesmanto, Selvanathan and Selvanathan, 'Analysis'

In recent years the views and experiences of central bank practitioners and specialists have also been published in regular updated surveys and articles – for instance, *How Countries Manage Reserve Assets*, a 2003 book edited by Pringle and Carver.⁷⁶ Sometimes the theory is contradicted by the practice. For instance, while DLM argued that external liabilities and assets should be managed together in order to optimise COFER, more than a decade later Pringle and Carver stated that among central banks the practice was ‘not widespread’.⁷⁷ However, the importance of intervention reserves for managing a currency peg is a given in these articles. Other reasons for intervention are to prevent a disorderly collapse in a floating currency, to manage and guide a floating currency, or, more controversially, to correct a long-run disequilibrium in asset markets which private markets have, for various reasons, failed to address.⁷⁸ Case studies continued to confirm the importance of currency pegging. The Danish central bank, managing a tight currency peg against the euro, was taking hardly any exchange risk other than in the euro.⁷⁹ Many developing and emerging countries have not taken advantage of greater exchange rate flexibility, continuing to intervene heavily, and, Williams argued, there is no evidence that greater use of exchange rate flexibility would influence their demand for reserves – a denial of Heller and Knight’s original claim.⁸⁰

It is also clear from these writings that the importance of intervention and other transactions depends in part on the size of a country’s reserves: ‘only countries with a high and stable stock of reserves enjoy the luxury of unrestricted investment choice’.⁸¹ Countries stressing debt service and imports for reserve adequacy tended to have low levels of reserves.⁸² Many central banks split reserves into different ‘liquidity’, ‘investment’ and ‘rainy-day’ sub-portfolios. The liquidity part would address

⁷⁶ Pringle and Carver, *How countries manage*

⁷⁷ Pringle and Carver, ‘How countries manage’, p10

⁷⁸ Goodhart, ‘Intervention’

⁷⁹ Hansen, Olgaard and Jensen, ‘Risk management’

⁸⁰ Williams, ‘The need for reserves’, pp34-5

⁸¹ Naameh, ‘Reserve management’, p149

⁸² Pringle and Carver, ‘How countries manage’, p14

intervention, the investment part might correspond to a targeted stable minimum level of reserves, which could be invested in bonds since it is unlikely to change (if necessary, the bonds could be converted into liquidity through repo financing), while the rainy-day fund might be invested in SDRs or gold as a kind of disaster insurance.⁸³ Persaud also recommended that the reserves required for intervention could be divided into liquid and illiquid portions in order to enhance yield, but their relative size should be based on the size of the FX market in the country concerned: a highly liquid FX market requires liquid intervention reserves.⁸⁴

Among these studies, Persaud's article considered how small, open economies, which naturally prefer fixed exchange rate arrangements, can adjust to a world characterised by major capital account crises. While policy credibility might be enhanced by formal, rule-based arrangements (either a clean float with inflation targeting, or harder fixes, such as currency boards and monetary unions), these are not suitable for many countries, which have instead accumulated large reserves to support currency pegs or heavily managed floating exchange rates. But the absolute scale of reserves required to defend against crises is too expensive to maintain, and holding relatively high reserves may not succeed as a strategy. Persaud's preference was that central banks arrange contingent credit lines contra-cyclically, allowing owned reserves to be focused on intervention and servicing the costs of such insurance.⁸⁵

From the above studies, it is apparent that central banks, mandated to preserve monetary and financial stability, prioritise security, liquidity and yield in their portfolios, they change slowly, and they are often constrained in their reserve management by transaction needs. But the requirements of individual central banks vary. There are times when security and loss-avoidance require making a pro-active shift in COFER,

⁸³ Naameh, 'Reserve management', pp148-51

⁸⁴ Persaud, 'The future', pp282-3

⁸⁵ Persaud, 'The future'

and there are institutional settings in which the deliberate pursuit of profit has taken place or is justified. This variety is shown in the literature around central banks' balance sheets and risk management.

The recent risk management literature recommends a pro-active integrated approach by central banks. Briere et al considered the risk of rising interest rates on central bank portfolios. Using monthly reserve data from 1986-2015, they identified risk-reducing and return-increasing strategies that could be applied to standard benchmark portfolios. Taken together, these strategies could greatly improve risk-return, reaching the efficiency frontier without (the authors argued) having to trade return against risk. For instance, a benchmark based on average central bank portfolios could be significantly improved in risk terms by introducing currencies such as the Australian and Canadian dollar which are weakly correlated to the US dollar. And allocations to mortgage-backed securities, high-yield corporate bonds and equities could significantly increase returns.⁸⁶ A similar point was made by Fisher and Lie about compartmentalised investment constraints (e.g. a defined liquidity sub-portfolio). By relaxing normal liquidity, currency, duration and credit constraints, they claimed that risk could be reduced by 150 basis points for the same return, or a similar return improvement obtained without additional risk.⁸⁷

With increasing transparency, central banks need to take a consistent, strategic but flexible approach to risk, as argued in a range of studies brought together by Bernadell et al.⁸⁸ Cardon and Coche recommended three steps: (1) a clear governance hierarchy, from oversight committee to investment committee to portfolio managers, setting (2) investment principles which meet policy requirements and derive (3) a long-

⁸⁶ Briere et al, 'Towards greater diversification'

⁸⁷ Fisher and Lie, 'Asset allocation'

⁸⁸ Bernadell et al, *Risk management*

term risk-return profile on which liquidity and currency constraints can be overlaid.⁸⁹ A variety of risk approaches can be discussed e.g. in currency reserve management, navigating between wealth preservation and liquidity preservation,⁹⁰ employing dynamic, stochastic methods to resolve different macro-policy and risk-return objectives,⁹¹ adopting a value-at-risk framework, using computer power to calculate continuously a probability of maximum acceptable loss within a given timeframe,⁹² or, when considering market risks, focusing on the outcomes necessary for continued central bank financial independence (profit generation, capital preservation and the risk of potential loss).⁹³ The risk management problems and approaches of central monetary institutions in, say, the Czech Republic,⁹⁴ Hong Kong⁹⁵ and Venezuela⁹⁶ are shown to be very different from each other in practice.

Pro-active currency shifts have been found in historical cases. Ugolini showed how the new National Bank of Belgium operated under a fixed silver standard in the 1850s. Because the central bank's foreign currency bills portfolio was opaque to outside observers, it used open market operations in this portfolio to present a strong free silver bullion⁹⁷ position to the market, and took advantage of other institutional aspects of the market to defer discount rate increases when the Belgian franc was under pressure. But, with the central bank enjoying excess resources funded by zero-interest government deposits, the FX portfolio was also actively managed in the pursuit of profit, the bank regularly 'buying low and selling high' among half a dozen currencies in this parity-based world, with considerable resulting variation in COFER.⁹⁸

⁸⁹ Cardon and Coche, 'Strategic asset allocation'

⁹⁰ Gintschel and Scherer, 'Currency reserve management'

⁹¹ Claessens and Kreuser, 'A framework'

⁹² Dwyer and Nugee, 'Risk systems'

⁹³ Boertje and van der Hoorn, 'Managing market risks'

⁹⁴ Bauer et al, 'Management of currency'

⁹⁵ Ho, 'Foreign reserves'

⁹⁶ Ruiz et al, 'Management of the international'

⁹⁷ 'Free' here means in excess of the fraction statutorily required to back banknotes

⁹⁸ Ugolini, 'The origins', especially pp63-6

The relative attraction of profit maximisation to central banks historically depended on their ownership, governance and mission. Serving shareholders, privately-owned central banks might pursue profits if not otherwise constrained. Flandreau showed how, early in the nineteenth century, concerns that privately-owned central banks were profiting through inflation at the expense of citizens led to them being constrained by simple rules such as specie convertibility; later, concerns that they were profiting from their discretionary market power in interest rate-setting during crises led to a restriction of the profits or dividends that could be taken from interest rates. Subsequently central bank independence from government emerged as a bargain between shareholders and citizens – profitable protected status for the shareholders, and the unimpeded prioritisation of the simple rule by the central bank, leading in turn to problems in the 1930s when the rule seemed to work against the welfare of citizens. Thus the adoption of rules or discretion and the independence of central banks have been related to time consistency and monitoring problems in their agency role.⁹⁹

The inter-war period presented two interesting cases of large changes in sterling exposures, driven by central banks with different institutional settings. Accominotti showed how the Banque de France, a privately-owned independent central bank with large sterling holdings, anticipated sterling's risk of devaluation and deliberately tried to protect its exposed capital position – firstly, by rebalancing its portfolio from sterling to dollars from June 1929; then, from October 1930, refraining from further sterling sales when it realised that such action would precipitate devaluation and the very capital losses that it was seeking to avoid – a situation described as a 'sterling trap'. The devaluation in September 1931 did indeed prove costly for the Banque de France, which had to be bailed out by the government and lost its independence as a result.¹⁰⁰ By contrast, Japan's FX holdings in the 1920s-30s were largely under government control, in a variety of exchange frameworks – floating exchange rates (1920-30), gold

⁹⁹ Flandreau, 'Pillars of globalization'

¹⁰⁰ Accominotti, 'The sterling trap'

exchange standard (1930-1), collapse and exchange controls (1931-4), stabilisation with sterling peg (1934-9), dollar peg (1939+). The currency mix between dollars and sterling fluctuated significantly, with sterling initially dominant, the dollar dominating immediately after the war, sterling recovering to pre-eminence in the mid-1920s and the dollar again by the end of that decade; sterling was again dominant by the mid-1930s and the dollar recovered the lead in 1939. The study showed a net debtor's strategic reserve policy towards the choice of 'reference currency' and portfolio mix that was focused on liquidity and security i.e. both transactional (interest payments, funding opportunities, ease of FX dealing, trade) and risk-minimising (stable reference currency) considerations.¹⁰¹

A final element to consider on the demand side of reserve management is politics. Helleiner argued that, in some cases, the economic arguments were insufficient to explain reserve management behaviour, and an important role for politics should be acknowledged. In Helleiner's taxonomy, politics intervened in two ways. Firstly, political factors could affect one or more of the three economic determinants of reserve currencies (he described these as confidence, liquidity and transactional networks but in effect they were the same as Lim's five factors) and thus influence a currency's economic attractions indirectly. Secondly, politics could intervene directly. This was relevant to currencies – such as sterling in the post-war years, as he argued – in which market actors did not play a significant role in conferring international status, and in which state authorities were not solely driven by economic considerations. In such cases states using an international currency ('follower states') would be influenced by domestic politics and political relations both with the currency issuer and other follower states, potentially volatile factors which could make the international currency particularly fragile. Note that Helleiner's political dimensions were not intended to be

¹⁰¹ Hatase and Ohnuki, 'Did the structure'

exclusive drivers of international currencies, but rather they augmented the arguments of the economists.¹⁰²

Taking stock of these supply and demand literatures together, a number of issues present themselves as relevant to a study of central bank reserves in the sterling area in the 1950s-60s. On the supply side (the UK in respect of sterling) there is a debate about costs borne by a country whose international currency faces potential decline. On the demand side, apart from any political aspects, there is the interplay between transactions and risk-return motives, related to perceptions about the adequacy of reserves, as well as the governance underlying reserve management, and the general institutional setting (liquidity and transaction costs in different financial centres, the international monetary system). It is particularly to the latter – the system of monetary rules and institutions – that we now turn attention. Most recent demand-side studies have taken place under floating exchange rate environments. The ‘elephant in the room’ for this thesis is the fixed exchange rate environment of Bretton Woods.

2.2 Monetary rules and institutions

Before reviewing the specific monetary institutions of that time, it is necessary to discuss terms. According to North, ‘institutions’ are constraints which guide human interactions. Their purpose is to reduce uncertainties and transaction costs (costs of measurement and enforcement) in human interaction arising from the complexity of problems, and individuals’ inability to solve them. These constraints can be formal (explicitly written) or, more pervasively, informal. Both types are significantly influenced by the effectiveness of enforcement. Institutional change occurs via a process in which institutions present incentives and opportunities, leading to actions by ‘organisations’

¹⁰² Helleiner, ‘Political determinants’, extending arguments of Strange, *Sterling*

(groups of individuals bound by a common purpose to achieve objectives), which alter the institutions.¹⁰³

By contrast, McKinnon took Mundell's definitions of monetary 'system' ('an aggregation of diverse entities united by regular interaction according to some form of control') and monetary 'order' ('the framework and setting in which the system operates').¹⁰⁴

McKinnon's 'order' thus equated to North's 'institution'. McKinnon's interest lay in defining the various monetary orders (sets of rules) which had taken place during 1879-1992. He described two such monetary orders for Bretton Woods, namely the 'Spirit of the Treaty' agreed in 1945, and the actual 'Fixed-Rate Dollar Standard' which really prevailed between 1950 and 1970.¹⁰⁵ The rules for the latter are repeated in full in Table 2. These rules were not recorded; instead they were McKinnon's interpretation of how the game was being played and how it might have continued. Thus McKinnon's 'rules' equated to North's 'informal constraints'.

¹⁰³ North, *Institutions* (pp3-4 for definitions of institutions/organisations)

¹⁰⁴ McKinnon, 'The rules', p1

¹⁰⁵ McKinnon, 'The rules', p2

THE FIXED RATE DOLLAR STANDARD, 1950-1970	
<i>Industrial countries other than the United States</i>	
I.	Fix a par value for the national currency with the U.S. dollar as the numeraire, and keep exchange rate within one percent of this par value indefinitely.
II.	Free currency convertibility for current-account payments; use capital controls to insulate domestic financial markets, but begin liberalization.
III.	Use the dollar as the intervention currency, and keep active official exchange reserves in U.S. Treasury Bonds.
IV.	Subordinate long-run growth in the domestic money supply to the fixed exchange rate and to the prevailing rate of price inflation (in tradable goods) in the United States.
V.	Offset substantial short-run losses in exchange reserves by having the central bank purchase domestic assets to partially restore the liquidity of domestic banks and the money supply (Bagehot's Rule).
VI.	Limit current account imbalances by adjusting national fiscal policy (government net saving) to offset any divergences between private saving and investment.
<i>The United States</i>	
VII.	Remain passive in the foreign exchanges: practice free trade with neither a balance-of-payments nor an exchange rate target. Do not hold significant official reserves of foreign exchange.
VIII.	Keep U.S. capital markets open to foreign governments and private residents as borrowers or depositors.
IX.	Maintain position as a net international creditor (in dollar-denominated assets) and limit fiscal deficits.
X.	Anchor the dollar (world) price level for tradable goods by an independently chosen American monetary policy.

Table 2: McKinnon's rules for the Fixed Rate Dollar Standard, 1950-70

Source: McKinnon, 'The rules', p16, Rule Box 3

Note that McKinnon's rules for the Fixed Rate Dollar Standard above were limited to industrial countries (including the UK), whereas his Spirit of the Treaty rules applied to all countries.¹⁰⁶ McKinnon did not explain this deliberate limitation, but the complication presented by the sterling area may have been one of the underlying reasons (alongside special consideration of developing countries and agricultural trade under Bretton Woods). McKinnon's interpretation was also based on the well-known redundancy problem, that equilibrium in N-1 currencies determines equilibrium in the Nth currency (here, the dollar). Rules VII to X addressed the redundancy problem of how to solve the extra degree of policy freedom.¹⁰⁷

¹⁰⁶ McKinnon, 'The rules', p13

¹⁰⁷ McKinnon, 'The rules', pp16-7

There is a technical problem here, associated with McKinnon's limitation of the rules to industrial countries: unless all countries engaged in trade are considered to be part of the system, the redundancy problem technically does not arise, so how did non-industrial sterling area countries fit in? McKinnon attributed sterling crises to the UK's breach of Rule IV – running over-inflationary policies.¹⁰⁸ Still, the logic of McKinnon's Rule Box based on the redundancy problem is that the sterling area as a whole (UK and RSA) should collectively, as a single entity, be following Rules I to VI. For instance, under Rule VI, the sterling area as a whole should be limiting current account imbalances and adjusting national fiscal policies.

McKinnon's Rules I-VI also incorporated the well-known Mundell-Fleming trilemma between fixed exchange rates, freedom of international capital movements and independent monetary policy (only two of the three are possible).¹⁰⁹ Under the 'Spirit of the Treaty', capital controls were supposed to facilitate adjustable pegs and national macroeconomic autonomy. But the 'Fixed Rate Dollar Standard' rules were different, with indefinitely fixed exchange rates (Rule I) creating an uneasy tension between, on the one hand, weakening capital controls (Rule II), and, on the other, short-term monetary autonomy (Rule V) together with long-term macroeconomic constraints (Rules IV and VI).¹¹⁰ A distinction has been made between the 1950s, when 'regional payments solutions replaced the global multilateralism that the Bretton Woods system had been supposed to create',¹¹¹ and the 1960s, when current account convertibility had been achieved and international capital flows, short-term and long-term, increased in speed and scale, leading to the trilemma-based policy conflicts which brought down the system.¹¹² According to the regional payments solutions argument, the sterling area, like the European Payments Union (EPU), had an instrumental purpose in the

¹⁰⁸ McKinnon, 'The rules', p23

¹⁰⁹ Mundell, 'Capital mobility'; Fleming, 'Domestic financial policies'

¹¹⁰ McKinnon, 'The rules', pp11-24

¹¹¹ Schenk, *The decline*, p9

¹¹² Schenk, *The decline*, pp8-11

1950s, which it no longer enjoyed following the achievement of current account convertibility. It is tempting to think that the sterling area's own national arrangements of currency pegging and capital controls corresponded nicely to those of the trilemma, but this would be to confuse capital controls designed to insulate a national economy (the classic trilemma) with the different capital controls required to insulate an integrated group of countries (the sterling area) from the NSA. As described above, the only consistent way to incorporate the sterling area into McKinnon's Rule Box is to treat the sterling area as a single entity governed by Rules I-VI.

There can be no doubt, as will be seen, that the sterling area operated under informal constraints in the North sense (there was no codification of rules), somewhat vague constraints which applied to the UK and RSA countries, typically on a variable and tacit bilateral basis between the UK and each country. Yet the sterling area also was presented as a public 'organisation' or coalition, like (but not the same as) the British Commonwealth, with a known membership defined by UK law. Certain practices, such as pegging to sterling, were easy to identify; and official documents, contemporary media and subsequent historiography often confidently described its rules as though they were quite formal.

Lipson's analysis of informal international agreements gives clues about why, like NATO or OPEC, this combination of public face and informal arrangements might have been an optimal combination for the sterling area. Since no international agreements, from public treaties to tacit agreements, are binding on the participants (there being no third-party enforcement), formal treaties are really about committing the state publicly via reputation. It is beneficial to the participants, and particularly to the originator and manager of such a system, to create a public impression of unity and voluntary stability. But formal treaties are hard to achieve, so informal agreements can substitute for them: they are typically secret, simple (unratified), flexible, and quick to negotiate.

Informal agreements also have corresponding disadvantages: they are less reliable, lacking public commitment and easier to abrogate. Informal agreements also vary according to the level of government involved and the form of the agreement – e.g. joint communiques, oral bargains, secret treaties and tacit agreements.¹¹³ The tacit bargains are hard to identify, or to distinguish from prudent self-interest. They may be a mirage, but they can sometimes be uncovered by reactions to violations of the perceived bargain: a tacit bargain is revealed by responses expressing regret more than surprise. They and hidden agreements can also easily lead to misunderstandings.¹¹⁴

Although its constraints were tacit, the public nature of the sterling area's presented rules, regularly repeated in contemporary media and the historiography (pegging to sterling, pooling reserves, and co-ordinating capital controls), may have reflected such a need to present commitment to an external audience. Implicit in McKinnon's rules and the trilemma is the concept of a stable equilibrium as a desirable international monetary objective. Equilibrium also was the focus of the 'rules versus discretion' debate in domestic monetary policy. Those favouring rules argued that discretionary monetary policy suffered from this problem of time-inconsistency. There were always short-term incentives to create inflation surprises, but in the long run they would result in higher inflation and therefore an inferior long-term equilibrium. The solution was credible formal rules, compared with which even reputation was a relatively weak commitment mechanism.¹¹⁵ Bretton Woods was a time of monetary discretion, when there was incomplete understanding of monetary policy.¹¹⁶ Still, public rules stressing stability, order and control would have served a reassuring purpose for the sterling area beyond the internal reasons for their creation.

¹¹³ As will be seen, all these, particularly tacit agreements, characterised sterling area diplomacy

¹¹⁴ Lipson, 'Why are some'

¹¹⁵ Kydland and Prescott, 'Rules'; Barro and Gordon, 'A positive theory'; Barro and Gordon, 'Rules, discretion'

¹¹⁶ Bordo and Schenk, 'Monetary policy cooperation', p24

As an inter-governmental institution, the sterling area had both economic and political dimensions. The interplay of economics and politics in this thesis is situated in the 'economic approaches to politics' dimension of political economy, which is concerned with economic reasoning. The specific application here is the 'economic analysis of institutions'.¹¹⁷ There are two broad schools in the economic analysis of institutions. One treats institutions as exogenous, and addresses the effects of institutions on economic behaviour and activity. The other regards institutions as endogenous, and is a theory of how institutions arise and how they change.¹¹⁸ Here there is an empirical focus on the institutional *effects* of the sterling area on reserves and reserve management and domestic financial systems, which takes the sterling area as a given.

The above discussion highlights the need for definitions in the thesis. Firstly, the Northian definitions of 'institution' and 'organisation' seem appropriate to this case. The word institution is often more conventionally applied to, say, facilitating bodies like the IMF or EPU, but these were both Northian institutions (sets of rules and constraints) and Northian organisations (groups of people including appointees and co-opted bureaucracies). However, while the sterling area was a Northian institution, it is by no means clear that it was an organisation. Those who discussed sterling area matters had other day jobs. So it is better, following North, to keep these concepts of institution and organisation separate. The sterling area was more a 'financial alliance' of countries than an organisation. (Occasionally it will be necessary to accept more conventional uses of the word institution, as in 'central monetary institution', meaning a Northian organisation such as a central bank). It should also be noted that a Northian institution is more than just constraints. North also emphasised transaction costs and

¹¹⁷ Caporaso and Levine, *Theories of political economy*, pp126-158

¹¹⁸ Caporoso and Levine, *Theories of political economy*, pp151-4

effective enforcement: 'an essential part of the functioning of institutions is the costliness of ascertaining violations and the severity of punishment'.¹¹⁹

Secondly, there is the use of the word 'rules'. Since much of the historiography has confidently described sterling area rules, it seems prudent to accept this term, even though we are really talking about Northian informal constraints, as distinct from written rules. These were usually tacit rules (interpreted here in the same way that McKinnon interpreted the rules of the Fixed Rate Dollar Standard), which need to be evidenced as far as they can. For the RSA countries, they were *British* rules in the sense of British officials' expectations of non-violation. Much of the historiography's discussion of rules has derived from British sources. We are describing reserve management 'practices' of peripheral central banks. Those practices might include following, or violating, perceived British sterling area rules. As already noted, tacit agreements lead to misunderstandings about what the rules actually are.

Thirdly, within the informal constraints which we will call rules, there are different types. North stressed the importance of 'conventions' that solve co-ordination problems, being rules that were never designed, and are maintained by mutual self-interest. He distinguished such self-enforcing institutions of exchange from those which required an element of enforcement, in which the institution served to reduce the costs of measurement and enforcement.¹²⁰ The distinction is important in the context of the sterling area because, as will be discussed, UK authorities liked to present the sterling area as a mutually self-interested club, ruled by conventions, which had evolved voluntarily as a matter of convenience – whereas in practice it witnessed some enforcing behaviour or enforcement debates among UK officials (e.g. regarding expulsion). The extent to which the sterling area operated via convention or elements of deliberate design and enforcement is therefore moot. This distinction can also be

¹¹⁹ North, *Institutions*, p4

¹²⁰ North, *Institutions*, pp40-2

linked to the taxonomy of political scientists, in which co-operation is tacit, negotiated or enforced.¹²¹

2.3 Monetary co-operation

Rules and constraints are closely linked to the concept of 'co-operation', which is the *raison d'être* of the Northian institution. The co-operation literature is related to general equilibrium theory, the costs of transacting, and particularly to game theory.¹²² Major insights of game theory are that co-operation is more sustainable in repeated games, where there are few players, information about players is easy to obtain, benefits significantly exceed costs (such as the public good externalities of a stable international monetary system), or players are not wholly driven by self-interested economic motives.¹²³ There are numerous definitions of different types of international monetary co-operation in the literature. For instance, a distinction was made by Bordo and Schenk between central bank 'co-operation' – 'the sharing of information and techniques of central banking, the discussion of common problems and occasional/ad hoc emergency lending or other operations between central banks in periods of financial crisis' – and 'co-ordination' – 'policy actions formally agreed and taken by groups of policy makers... aimed at achieving beneficial outcomes for the international system as a whole'.¹²⁴ While this division served the authors' purpose well, in the sterling area I prefer a distinction between talk (to be defined as 'consultation') and all forms of action (encompassed by the word 'co-operation'). This is not to devalue co-operative consultation, or the types of active co-operation possible, but to reflect the different balance between consultation and active co-operation in the sterling area, and to focus on the revealed preferences of action. Using Toniolo's definitions, I also

¹²¹ Toniolo, *Central bank cooperation*, p11

¹²² Key works include Arrow and Hahn, *General competitive analysis*; Coase, 'The problem'; Axelrod and Hamilton, 'The evolution'; Sugden, *The economics*; Taylor, *Anarchy and cooperation*

¹²³ See North, *Institutions*, pp12-16; Toniolo, *Central bank cooperation*, pp9-13

¹²⁴ Bordo and Schenk, 'Monetary policy cooperation', p3

distinguish 'formal co-operation' (meaning ad hoc agreed actions of all types, however simple or elaborate) and 'informal co-operation' (meaning the longer-term following of rules of the game, which is a less demanding form of co-operation linked to repeated behaviour and reputation).¹²⁵

It is instructive to consider the forms of international monetary co-operation that took place during the Bretton Woods years, and relevant comparisons with those of other periods. Bordo and Schenk's recent survey related the effectiveness of domestic monetary rules to the effectiveness of international co-operation. They argued that, if domestic monetary rules acted as credible commitment mechanisms (as under the classical gold standard 1880-1914 or the 'Great Moderation' 1985-2006), then international monetary co-operation performed a limited role, such as international lender of last resort activity, and was largely successful in this. However, in the intervening years, domestic monetary rules were usually not credible or consistent with international objectives, such as fixed exchange rates, and international co-operation was therefore unsuccessful.¹²⁶

The authors' criticism of Bretton Woods was that there was 'no underpinning domestic rule to support the system',¹²⁷ and the USA pursued inflationary policies from 1965. In other words, McKinnon's Rules IV-V, each running in opposite directions, and Rule X, were not backed by a credible domestic commitment mechanism. At the same time, however, there was 'an elaborate effort at institutionalized coordination'¹²⁸ in these years, which reflected a consensus that the Great Depression period had been a co-operative failure, and stable conditions favourable to the growth of international trade needed to be prioritised, e.g. via the IMF or BIS. The authors highlighted three major efforts to defend pegged exchange rates in the 1960s, namely the Gold Pool, co-

¹²⁵ Toniolo, *Central bank cooperation*, p5

¹²⁶ Bordo and Schenk, 'Monetary policy coordination'

¹²⁷ Bordo and Schenk, 'Monetary policy coordination', p24

¹²⁸ Bordo and Schenk, 'Monetary policy coordination', p16

ordinated lines of credit among G10 central banks, and bilateral swap lines between the Federal Reserve and other major central banks.¹²⁹ These efforts at co-operation had varying success and prolonged the system, but the system ultimately foundered on inconsistencies with domestic policies. The key insight is that rules and co-operative organisations together can shape international monetary co-operation. Other authors have adopted more positive views about the role of, and need for, international monetary co-operation.¹³⁰ This debate is partly about short-term and long-term horizons and priorities.

Implicit in the debates around Bretton Woods are three different types of co-operation. One is the co-operation involved in the creation and design of a stable international monetary system. The second is the co-operation involved in trying to make the system work well, and to improve flaws in its design, or address changes in external conditions, in order to maintain it as a stable system. The third is the co-operation involved in keeping it together through short-term fixes, effectively 'fire-fighting'. These forms of co-operation address different aspects of stability, the first two considering fundamentals, the third short-term confidence.

McKinnon's Rule Box looked at the first question, and sought to interpret the de facto rules of Bretton Woods. This is easier to do than for the sterling area because of the open, public and multilateral nature of the design debates underlying Bretton Woods. Fixed exchange rates, and growing multilateral trade, were at the core of the designers' aims. Still, there have been other interpretations about these rules. For instance, McKinnon argued that the gold-dollar parity was not essential to its stability, while Eichengreen called it a 'gold-dollar system'.¹³¹ Others have looked through the rules and argued that the system was stable for other reasons. For instance, as

¹²⁹ Bordo and Schenk, 'Monetary policy cooperation', pp20-3

¹³⁰ Borio, Toniolo and Clement, *Past and future*; Toniolo, *Central bank cooperation*

¹³¹ Eichengreen, *Global imbalances*, p10

already noted, there is the argument that there was a long-term stable bargain between the USA on the one hand (exorbitant privilege), and Europe and Japan on the other (export-led growth), which the USA has revived more recently with China and other industrialising countries.¹³² There was also the 'banker to the world' view of US deficits of the time, suggesting that borrowing short and lending long was profitable and stable (banks can lend a multiple of their reserves and depositors cannot all withdraw their funds at the same time).¹³³

The second type of co-operation tried to address fundamental flaws. Bordo, while recognising the macroeconomic achievements of the system, highlighted three fundamental problems: the growth of liquidity, asymmetry of adjustment, and confidence in the dollar.¹³⁴ The liquidity problem was a dilemma highlighted by Triffin: scarce gold was inadequate for the world's growing liquidity needs, but dollars could not expand sufficiently without jeopardising confidence in its value relative to gold.¹³⁵ The adjustment problem was related to the trilemma. With more liberal capital flows, lower growth led to increased distributional conflicts and greater policy priority towards internal balance, putting pressure on fixed exchange rates.¹³⁶ In practice creditor countries such as West Germany found it easy to resist revaluation, and the pressure to adjust fell on the debtors.¹³⁷ Finally the dollar confidence problem was related to the already-mentioned 'credibility' of the commitment of the USA (at the core of the system) to its creditors. Compared with the universal rules of the classical gold standard, Bordo and Kydland argued, Bretton Woods lacked credibility, because for the USA there was 'no explicit enforcement mechanism other than reputation and

¹³² Dooley, Folkers-Landau and Garber, 'The revived Bretton Woods'. See Eichengreen, *Global imbalances*, p4 for a critique

¹³³ Despres, Kindleberger and Salant, 'The dollar'. For a critique, see Eichengreen, *Global imbalances*, pp136-43

¹³⁴ Bordo, 'The Bretton Woods', pp50-73. Liquidity, adjustment and confidence were principal challenges facing Bretton Woods (Connell, 'Fritz Machlup')

¹³⁵ Triffin, *Gold*

¹³⁶ Eichengreen, 'The Bretton Woods', pp224-5; James, *International monetary cooperation*, pp226-7

¹³⁷ McKinnon, 'The rules'

commitment to gold convertibility'.¹³⁸ When the USA adopted inflationary policies after 1965, major countries in the system's periphery were reluctant to follow US leadership.¹³⁹ There seems to be a consensus in the historiography that co-operative efforts were directed too much to trying to solve the 'problem' of liquidity (e.g. through the long and ultimately fruitless debates leading to the creation of the IMF's Special Drawing Rights), and not enough to the problems of adjustment and credibility.¹⁴⁰ The inevitability of the breakdown of Bretton Woods remains the prevailing view.¹⁴¹

Bretton Woods, then, was a vulnerable regime, 'rigid and brittle',¹⁴² forming a transition between the shared assumptions of the gold standard, and the free-for-all of floating exchange rates.¹⁴³ Consequently much of the co-operation effort was directed towards supporting prevailing exchange rate parities in the short term, both between gold and the US dollar, and between the US dollar and other currencies.¹⁴⁴ Since Bretton Woods was the overarching framework in which the post-war sterling area operated, and the sterling area was a form of regional co-operation within it, it is instructive to look at two other examples of such regional co-operation, the 1960s Gold Pool and the 1950s EPU.

The Gold Pool was designed to protect the gold-dollar parity, by involving in the USA's market defence of the parity seven European countries with a collective interest in preserving the Bretton Woods system. Eichengreen observed that the Gold Pool of 1961-8 'collapsed after six years and barely two years after sustained sales of gold commenced',¹⁴⁵ so it was not particularly successful. He likened it to a cartel with a

¹³⁸ Bordo and Kydland, 'The gold standard', p121. That Bretton Woods lacked credibility was supported by Giovannini ('Bretton Woods')

¹³⁹ Bordo, 'The Bretton Woods', p83

¹⁴⁰ Bordo and Schenk, 'Monetary policy cooperation'; Meltzer, 'U.S. policy'

¹⁴¹ James, 'The multiple contexts', pp421-2. James argued that the system was more sustainable than it seemed, and attributed its demise to a domestic political economy trade-off in the USA, which sacrificed the international monetary system while preserving trade openness (pp422-4)

¹⁴² Eichengreen, 'The Bretton Woods', p315

¹⁴³ Cesarano, *Monetary theory*

¹⁴⁴ Coombs, *The arena*; Bordo and Schenk, 'Monetary policy cooperation', pp14-27

¹⁴⁵ Eichengreen, *Global imbalances*, p71

number of weaknesses: (1) lack of a shared diagnosis of the problem, (2) no enforcement mechanism, (3) a free-riding, non-compliant competitive fringe of countries outside the Gold Pool, (4) incompatibility with the market-based official image of Bretton Woods, (5) lack of public transparency, reducing commitment and confidence, and (6) dynamic instability, as dollar reserves increased relative to gold.¹⁴⁶

By contrast, the EPU (1950-8) has been judged a successful co-operative enterprise involving 18 European countries, which 'promoted multilateral settlements, encouraged the removal of trade barriers, and cemented the stability of exchange rates',¹⁴⁷ only liquidating itself when the Bretton Woods goal of current account convertibility had been attained. Kaplan and Schleiminger claimed that its greatest benefits were intangible: 'European economic integration and financial co-operation'.¹⁴⁸ The EPU framework engendered a co-operative spirit during complex negotiations over the management of specific intra-European problems and crises.¹⁴⁹ Toniolo highlighted the importance of 'the EPU mechanism, which somehow obliged its board to press for adjustment both by deficit and surplus countries'.¹⁵⁰ Eichengreen argued that the EPU was not technically required (Europe could have moved earlier to convertibility) and its significance lay in the support it provided to the social cohesion in Europe which underlay rapid growth in these years.¹⁵¹ By contrast Toniolo suggested that earlier convertibility would have been premature, and the EPU enabled first the liberalisation of intra-European trade, generating gains from competition while discriminating against US goods and protecting European incomes, and subsequently the gradual liberalisation of extra-European trade.¹⁵²

¹⁴⁶ Eichengreen, *Global imbalances*, pp65-8

¹⁴⁷ Toniolo, *Central bank cooperation*, p327

¹⁴⁸ Kaplan and Schleiminger, *European Payments Union*, p356

¹⁴⁹ Toniolo, *Central bank cooperation*, pp335-46

¹⁵⁰ Toniolo, *Central bank cooperation*, p338

¹⁵¹ Eichengreen, *Reconstructing*

¹⁵² Toniolo, *Central bank cooperation*, p346

In contrast to the multilateral overarching framework of Bretton Woods, it should be observed that these were both discriminatory arrangements. Each also had administrative organisational underpinnings. In the case of the Gold Pool, the UK acted as agent of the Pool's members, with the agent's dealings being shared pro rata among the members according to fixed proportions. As well as having precise rules about the mixture of gold and credit in monthly settlement, the EPU had strong governance in the form of the EPU managing board, with ad hoc problems being negotiated throughout the 1950s. Both these regional arrangements offer a comparison against which the sterling area can be assessed.

To summarise on rules, institutions, organisations and co-operation, the international monetary framework of the 1950s-60s was highly institutionalised, co-operative and governed by rules. The discussion highlights the importance of both informal constraints and consistent, credible domestic policies within an international monetary system. But the sterling area's position in that framework is shadowy and hard to extricate. Informal, tacit agreements are difficult to identify. If the IMF's members including the UK were all pegging closely to the dollar, what did it mean for sterling area countries to be pegging to sterling? While institutions such as the Gold Pool (1961-8) and EPU (1950-8) were clearly formed to support the Bretton Woods framework, the practices of the sterling area, such as reserve pooling, long pre-dated Bretton Woods, so to what extent was the sterling area truly an interim solution 'formed to allow multilateral trade without full convertibility'?¹⁵³ In short, did the sterling area matter? The next section reviews the sterling area and its associated literature.

¹⁵³ Bordo and Schenk, 'Monetary policy cooperation', p15

Section 3: Monetary and exchange arrangements of the sterling area: critical discussion of the literature

This section discusses the sterling area literature in three parts. Firstly, it reviews the British exchange controls which defined the sterling area. Secondly, it discusses the reciprocal rules of the sterling area system. Thirdly, it considers the 'problem of the sterling balances' which dominated policy in relation to the sterling area. We begin with a brief overview of the relevant sterling area literature.

Alongside more general references, there are three types of specialist literature regarding the sterling area, overlapping in places, but recognisable. Most of this literature has been centred on the UK, although some authors took the viewpoint of a sterling area member.¹⁵⁴ First were thorough contemporary analyses, particularly in the early 1950s, seeking to explain the global role of, motivations behind, and prospects for the sterling area. An example is the 1951 mission study by the United States' European Cooperation Administration (ECA). For the ECA, the sterling area's importance derived from its scale (comprising a quarter of the world's population and international trade), its sourcing of resources (it produced half the world's gold, while leading net exports included wool, rubber, jute, tin, cocoa, diamonds and tea), and its cohesion.¹⁵⁵

Given the technical nature of the sterling area, and client secrecy surrounding its workings, it was inevitable that this literature should be informed by contact with (and perhaps carry the blessing of) UK officialdom. Nevertheless, not all analyses were optimistic about the future prospects of the sterling area in the face of decolonisation, and from the mid-1950s, a second type of literature emerged which was highly critical of UK official policy. Taking their cue from frequent sterling crises, its authors accused

¹⁵⁴ Perkins, *Britain and Australia*

¹⁵⁵ Cassels, *The sterling area*, preface and pp13-14, 79

UK officials of imposing domestic economic costs on the UK in pursuit of international prestige. Leading works in this genre were those of Shonfield and Strange.¹⁵⁶

Thirdly, there is the historical literature. With the collapse of the sterling area in the 1970s and the apparent vindication of the critics, interest in the topic waned. During these years, historical memoranda were produced by UK Treasury insiders on different aspects: while they are technically TNA primary documents, they were historically motivated in-depth studies, and have been sufficiently cited that I have treated them as secondary material for this review. Then, with the opening up of government historical archives from the 1990s, external historians engaged with sterling area material.

Schenk began by making a close study of the 1950s sterling area, analysing archival documents, and subsequently extended this to later periods and work in other countries. The conclusions were revisionist, criticising the critics and arguing that their assertions about economic costs for Britain were not supported by the primary material. Other historians have not delved so deeply, but there have been individual studies of sterling area countries, including reserve management and international financial relations and negotiations with the UK. However, it is fair to say that the focus has been on specific issues, and, unlike in the first category, sterling area rules and practices, although mentioned, have been in the background. If this review appears to draw heavily on Schenk and contemporaries, it is because these have made in-depth studies of the monetary and exchange arrangements of the sterling area.

The point about this for a new researcher looking at the sterling area in the 1950s-60s is that the sterling area was a highly contested policy topic in the UK, and other countries. There were critics on the outside (and the inside) attacking official policy. And there were officials on the inside both defending policy against the critics and trying to present the sterling area as a source of stability in the face of sterling crises.

¹⁵⁶ Shonfield, *British economic policy*; Strange, *Sterling*

In other words, while there was an explicit critique of the sterling area in the secondary literature, there was also an implicit official narrative. This narrative was not presented explicitly in the secondary literature, but it can be found in primary documents and in parts of the secondary literature. This makes a documentary study of the sterling area particularly challenging. Minimum questions which a researcher must ask of any document, primary or secondary, include the following. How well-informed was the author about the sterling area? What was the source of the author's information? And what was the standpoint of the author, or the author's source, in this contested field?

So there have been numerous studies of the sterling area at different times, but sterling's international use was subject to change over many years, from the nineteenth century to the 1970s and beyond, and not all versions have been consistent or clear. With rules hard to pin down, many authors have preferred to emphasise the general fluidity of arrangements, painting a picture of the post-war sterling area as a cohesive association of countries, whose importance lay not so much in their banking arrangements but in their trading relations.¹⁵⁷ However, in terms of monetary and exchange arrangements, a more precise technical exposition of the sterling area is needed, and was provided by Sargent's discussion of UK exchange controls in 1952. Sargent's summary has the benefit of being well-informed, analytical and explanatory (type 1 in the above literature categorisation), but not uncritical.¹⁵⁸

3.1 The sterling area as defined by UK exchange controls

Sargent made the argument that any currency area rests on two principles of discrimination. Firstly, international transfer of currency within the area is easier than a transfer from inside to outside. Secondly, it is easier for (some or all actors resident in) a country inside the area to transfer the currency outside the area, or to exchange the

¹⁵⁷ Cassels, *The sterling area*, p13; Grey, 'The sterling area', p129

¹⁵⁸ Sargent, 'The sterling area', also referenced by Capie (*Bank of England*, p146)

currency for an outside currency (the right of convertibility), than is the case for a country outside the area. The sterling area thus arose from inconvertibility and exchange controls. 'As long as the pound sterling was a fully convertible currency... there was no Sterling Area'.¹⁵⁹ This means that the sterling area's monetary and exchange arrangements cannot be considered in isolation but have to be judged in the wider relative context of those between the UK and NSA countries.

Before 1931, various countries held substantial amounts of sterling in their international reserves, for the reasons given in Section 2. These reasons included: convenience in terms of trade, debt service or liquidity, such as London's role in financing trade and providing debt capital; sterling's status as a leading gold-convertible currency under the pre-WW1 gold standard and the 1924-31 gold exchange standard; and considerations of risk and return.¹⁶⁰

In 1931, sterling's convertibility into gold at a fixed rate ended, and sterling floated on the currency exchanges. There was a period of currency confusion, but by 1933, a loose 'sterling bloc' of countries had emerged, which pegged their currencies to sterling at a fixed rate without exchange controls. According to Sargent, these countries were the British Dominions (except Canada), the British colonies, Egypt, Denmark, Norway, Sweden, Finland, Estonia, Portugal and Siam.¹⁶¹ But Sayers noted that the exact membership of the bloc, if defined as 'the area in which sterling circulated most easily', was hard to pin down.¹⁶² The sterling bloc enjoyed the practical advantage of mutual trade at a fixed exchange rate which satisfied Sargent's first

¹⁵⁹ Sargent, 'Britain', p531

¹⁶⁰ Sargent, 'Britain', p532

¹⁶¹ Sargent distinguished the above countries from more restrictive sterling peggers: Japan, Greece, Latvia, Yugoslavia, Argentina and Bolivia (Sargent, 'Britain', p532). The Dominions apart from Canada/Newfoundland were Australia, pre-partition India, Ireland, New Zealand and South Africa. However, Sargent did not mention Iraq, Iran or Uruguay, all referenced within the sterling bloc by Cassels (*The sterling area*, p26)

¹⁶² Sayers, *Financial policy*, p228

principle, but he said that this was a matter of convenience rather than a special privilege, as sterling remained convertible world-wide.¹⁶³

War in 1939 forced the UK to introduce exchange controls in order to protect its international reserves, and the sterling area then came into being as a distinct smaller group of countries, defined by British exchange controls. The sterling area now satisfied both of Sargent's principles.¹⁶⁴ As Sayers explained, these controls were debated and introduced over time, and their design reflected a compromise between the liberal 'good banker' approach which would help supply credit to the UK, and the strict German exchange control system which would preserve precious resources. They began with the mobilisation (the sweeping up into the Treasury's Exchange Equalisation Account (EEA) at the Bank of England) in the UK of all 'designated' hard currencies and gold, and strict Treasury control over subsequent use of these assets, policed by agent banks.¹⁶⁵ The regulations included the additional Treasury control of sterling payments to non-residents. The sterling area countries were those countries specifically exempted from formal British control over sterling payments. This was only feasible because of assurances from sterling area countries that 'exchange restrictions substantially parallel to those enforced by the United Kingdom' would be imposed.¹⁶⁶ The sterling area initially comprised the entire British Commonwealth (including neutral Ireland but excluding Canada, Newfoundland and Hong Kong), together with Egypt, Sudan and Iraq.¹⁶⁷ In order to gather hard currency, the UK introduced dollar-invoicing for exports to the NSA, and bilateral payments agreements (regarding sterling's use) with NSA countries, at each step securing the agreement of sterling area countries.¹⁶⁸ The administration of controls in the sterling area was thus decentralised at a national level, but, through central bank contacts, enjoyed 'a considerable degree of

¹⁶³ Sargent, 'Britain', pp532-3. That the 1930s 'sterling bloc' was based on convenience rather than privilege or negotiation is the general view. See Drummond, *The floating pound*

¹⁶⁴ Sargent, 'Britain', p533

¹⁶⁵ Sayers, *Financial policy*, pp226-34

¹⁶⁶ Sayers, *Financial policy*, p235

¹⁶⁷ Sayers, *Financial policy*, pp235-6

¹⁶⁸ Sayers, *Financial policy*, pp236-51

coordination'.¹⁶⁹ There was a 'partial pooling' into the UK of the hard currency resources of the sterling area, South Africa being an exception.¹⁷⁰ In return, as central banker for the group, the UK agreed to supply automatically the hard currencies required for necessary imports from the NSA by sterling area countries. In RSA countries, capital transactions were controlled by direct regulations, and imports were controlled by import licensing. Through this control, the UK was able to pay for war supplies with sterling, in effect additional sterling credit – about £2.5bn from the RSA, and £0.5bn from the NSA.¹⁷¹

The UK emerged from the war with two major problems: an urgent current account deficit until the recovery of exports, and the threat of redemption posed by these large sterling reserve holdings – the 'sterling balances'.¹⁷² For the RSA countries, there were similar concerns about how imports from the dollar area would be financed.¹⁷³

Reflecting these concerns, the British exchange control arrangements carried over into the post-war period. The years 1945-9 remained a 'bilateral phase' of fixed exchange rates, as described by Tew. There were widespread controls internationally, and, outside the sterling area, countries would only accept limited amounts of each other's currency before requiring settlement in hard currency, either gold or US dollars.¹⁷⁴ This much had not changed, but the context was now different. The common purpose of war aims, and the difficulties of wartime trade, had previously acted as significant constraints on sterling area spending. The need for effective controls was even greater in the period of reconstruction, pent-up demand and dollar scarcity that followed the war. The sterling area's special exempt status was formalised as the 'scheduled

¹⁶⁹ Cassels, *The sterling area*, p27

¹⁷⁰ Cassels, *The sterling area*, p27

¹⁷¹ Cassels, *The sterling area*, pp27-8

¹⁷² Sayers, *Financial policy*, p271

¹⁷³ Cassels, *The sterling area*, p28

¹⁷⁴ Tew, *The evolution*, pp15-32

territories' under new legislation, The 1947 Exchange Control Act. The UK's exchange control system became more complex and nuanced.¹⁷⁵

How can we track the many sterling exchange control changes that took place in the post-war period? According to Tew, after the bilateral phase (1945-9), there followed a binary period (1950-8), in which there was considerable free use of sterling outside the dollar area, and finally the years of multilateral convertibility after December 1958.¹⁷⁶

One needs a starting point of reference. Again, Sargent provided a succinct tabular summary of British exchange control, which showed the sterling area's privileged position in the freedom of sterling payments in 1952. This is reproduced as Table 3.

With some qualifications (described by Sargent and below), sterling could be transferred freely within the sterling area for either current or capital purposes, and sterling was also effectively convertible for use everywhere else by drawing on the sterling area's 'dollar pool' (the hard currency reserves held by the EEA).¹⁷⁷ The three qualifications were as follows. Firstly, current spending was constrained by import licensing and government contracts. Secondly, unlike the UK, certain sterling area countries (Australia, New Zealand and South Africa) restricted capital flows to the sterling area, and South Africa also withdrew from the pooling arrangements in December 1947. Thirdly, as a result of events in 1947 (see below), the sterling holdings of certain sterling area countries (e.g. India, Pakistan, Ceylon and Iraq) were temporarily blocked and hard currency spending rations were imposed on them.¹⁷⁸

¹⁷⁵ Cassels, *The sterling area*, pp28-9

¹⁷⁶ Tew, *The evolution*, pp15-57.

¹⁷⁷ Sargent, 'Britain', pp533-42

¹⁷⁸ Sargent, 'Britain', pp538-42

Sterling held by residents of:	Freely transferable within area shown		Freely transferable to outside area shown	
	For current transactions	For capital transactions	For current transactions	For capital transactions
American Account Area	Yes	*	Yes	*
Sterling Area	Yes	Yes	Yes	No
Transferable Accounts Area†	Yes	No	No‡	No
Bilateral Area and Residual Group	No	No	No¶	No

Table 3: The sterling exchange control system, 1952

Source: Reproduced from Sargent, 'Britain', p535

Notes:

* Sterling Balances only; sterling held in the form of securities can be transferred outside sterling area only in the event of repayment

† Sterling in transferable accounts only

‡ Except for payments to Residual Group and Sterling Area

¶ Except for payments to Sterling Area

Sargent's table described the transferability of sterling (the obverse of convertibility) on current and capital account for countries categorised by British exchange controls.

Compared with the wartime controls, the only important new category in Sargent's table was the Transferable Accounts Area. The American Account Area was granted official convertibility (effectively during and) after the war, in order to discourage exchanges in the unofficial, free sterling market. During the war, countries with bilateral agreements with the UK could only spend sterling in the sterling area (becoming the Bilateral Area in Sargent's table). The Residual Group only differed from the Bilateral Group in that it could receive payments from the Transferable Accounts Area.¹⁷⁹

Transferable accounts emerged out of the Bank of England's plan to implement the American Loan Agreement of 1945, which, in return for US\$3.75 billion of low-interest long-term funds, required the UK to settle outstanding sterling balances (either cancelling, blocking or releasing them), and to bring in non-discrimination and currency convertibility by mid-1947.¹⁸⁰ The British plan was to introduce convertibility country by country into the NSA in the year running up to the deadline (it was argued that the

¹⁷⁹ Sayers, *Financial policy*, pp247-51; Sargent, 'Britain', pp533-5

¹⁸⁰ Peden, *The Treasury*, pp360-2; Pressnell, *External economic policy*, pp262-355; Gardner, *Sterling-dollar diplomacy*

sterling area already enjoyed convertibility through the dollar pool). Each relevant NSA country was asked to negotiate a transferable account agreement with the UK, agreeing to accept sterling without question in current trade in return for the right to transfer the sterling to the American Account Area or to exchange it with the UK for hard currency. Transferable accounts thus occupied a place in the exchange control hierarchy just below the sterling area and above the bilateral area. This meant that when convertibility had to be suspended in the sterling crisis of August 1947, the suspension was administratively a simple matter: a change to each transferable account agreement so that transfers to the American Account area were no longer allowed. In addition, certain countries which had proved a source of dollar drain for the UK (e.g. Argentina, Belgium, Brazil and Canada) were reallocated from the transferable accounts area to the bilateral area.¹⁸¹

Thus the sterling area's 'privilege' was in relation to these other areas, and in this relative assessment it mattered which countries were in which area, particularly the transferable accounts area, since this area enjoyed some freedom of transferability.¹⁸² In 1952, the sterling area was little changed from its wartime composition, consisting of 'the British Colonies, South Africa, Australia, New Zealand, India, Pakistan, and Ceylon, together with certain countries outside the British Commonwealth, Burma, Iraq, Jordan, Iceland and the Irish Republic'.¹⁸³ Egypt, Sudan and Palestine had departed the area in the 1940s. Libya was persuaded to join in 1952. Following regime changes, Iraq left in 1959, Southern Rhodesia (formerly a colony) in 1965, Burma in 1966. These membership changes were recorded and explained in Symons' memorandum.¹⁸⁴

¹⁸¹ Fforde, *Bank of England*, pp132-41; TNA:T267/3, 'The convertibility crisis of 1947', Ellis Rees, 1962. In Sargent's table the only difference for the pre-suspension arrangements would have been to add the words 'and American Account Area' to the note marked ‡

¹⁸² Originally a sterling area member, Egypt joined the transferable accounts area in 1947; in Jul/1956 (Suez crisis) it was removed from this category and its sterling balances were blocked (Fforde, *Bank of England*, pp117-20, 550)

¹⁸³ Sargent, 'Britain', p533

¹⁸⁴ TNA:T267/29, 'Sterling balances'

In the 1950s, transferable accounts became the principal instrument of the British drive to extend the use and acceptability of sterling, and also towards 'non-resident' (i.e. NSA) convertibility.¹⁸⁵ The creation of the EPU in July 1950 led to a significant widening of the transferable accounts area during 1950-51: it now incorporated most Western European countries. Through the multilateral settlement rules for intra-EPU trade, the EPU provided de facto partial (and, during 1950-8, increasing) gold- or dollar-convertibility to its members' currencies. The EPU also required the gradual removal of intra-EPU import controls. The whole sterling area was included in the EPU trading arrangements via the UK's membership, so that the UK's EPU surpluses and deficits were in fact those of the sterling area as a whole. The EPU thus constituted a major step towards free trade outside the dollar area. In March 1954 there was a further widening of the transferable accounts area, encompassing most of the non-dollar non-sterling area (NDNSA), and extension of the freedoms granted within the area (transferable accounts were no longer restricted to central monetary institutions, and capital as well as current payments were liberalised). Then in February 1955 the Bank of England began intervening in unofficial transferable sterling exchange markets such as those located in Zurich and New York, to ensure that the free rates quoted no longer diverged by more than about 1 per cent from the official sterling-dollar exchange rate. This meant that de facto non-resident convertibility had been achieved. In December 1958 the American account and transferable accounts areas were merged, thus establishing formal non-resident convertibility. In February 1961, as the UK adopted Article VIII of the IMF's rules, all UK controls on current payments (such as import controls) were prohibited.¹⁸⁶

¹⁸⁵ On the drive to convertibility, see Tew, *The evolution*, pp15-66; Burnham, *Remaking*; Fforde, *Bank of England*, pp166-313, 475-605

¹⁸⁶ Tew, *The evolution*, pp33-43

In short, the sterling area lost its relative current payments privilege during the 1950s, significantly in 1950 with the EPU, de facto in February 1955, and completely in December 1958 with convertibility. This left freedom of capital flow from the UK as the principal privilege that persisted into the 1960s. The UK's long-standing policy of capital controls affecting UK residents towards the NSA fluctuated during the 1960s, first loosening, then tightening, but always remaining in place.¹⁸⁷ The exemption from UK control of sterling transfers towards the sterling area (the definition of the sterling area) did not end until June 1972.¹⁸⁸ Still, there were indirect and moral suasion measures addressing UK capital flow to the sterling area. First, in July 1961, the UK Chancellor expressed concern publicly about capital outflows to/the lack of remittances from the RSA (while introducing formal NSA capital control measures). More significant were the UK's imposition of Corporation Tax in April 1965 (removing tax advantages for overseas investment) and the 'Voluntary Programme' introduced in May 1966 as a temporary measure (rolled over in subsequent years) to restrain direct investment into Australia, New Zealand, South Africa and Ireland.¹⁸⁹ Since these were the countries principally benefiting from UK capital flow, the sterling area's capital flow privilege was thus reduced.

If, following Sargent, privilege and discrimination were the *raison d'être* of the sterling area, it is the decline of the sterling area's privileged status during the 1950s-60s that makes these years particularly interesting. Sterling area countries enjoyed a mechanism of easy access to Western European and other NDNSA trade in the 1950s in Tew's 'binary phase', but the relative advantage was less clear after convertibility.¹⁹⁰ The difficulty was summarised by the economist Scammell in 1961. He had described the sterling area as 'one of the most successful voluntary organisations for mutual

¹⁸⁷ TNA:T267/34, 'Exchange control 1959/1972; U.K. attitudes and actions', Symons, 1975; Schenk, *The decline*, pp215-23

¹⁸⁸ The exempt 'scheduled territories' were now redefined as the UK, the Channel Islands, the Isle of Man, Ireland and Gibraltar (Capie, *Bank of England*, p711)

¹⁸⁹ TNA:T267/34, 'Exchange control 1959/1972', pp6-38

¹⁹⁰ Benefit explained by Meyer, *Britain, the sterling area*, p93

monetary advantage ever evolved',¹⁹¹ but was now beginning to question its purpose and prospects:

'The Sterling Area has been three things in its day; a fixed exchange club of countries with broadly similar interests and policies; a group organised for economic warfare; and a group organised for defence against the dollar problem. At no stage have objects been defined.'¹⁹²

So the sterling area still existed under the definition of UK exchange controls in 1960, but its reason for existing was much less obvious than in 1948. Why did it then persist until 1972? Or was this persistence a mirage, and were sterling area countries not operating under constraints at all – in essence was the sterling area an irrelevance? Some authors seem to have thought so. Contrary to the UK exchange control definition of the sterling area, Kirshner said that, after 1958, the sterling zone, which no longer needed a dollar pool, shrank to only Britain and its remaining colonies.¹⁹³ Robertson and Singleton stated that dollar pooling ended in 1958.¹⁹⁴ This historical uncertainty about what the sterling area was, and was for, demands another definition of the sterling area, based on its operating practices.

3.2 The sterling area defined by working practices and British rules

The previous sub-section showed that membership of the sterling area was the unilateral decision of the UK government. In return for an exemption from UK exchange controls, however, the British expected sterling area countries to follow certain rules. In the sterling area literature these rules have been expressed fairly

¹⁹¹ Scammell, *International monetary policy*, p244

¹⁹² Scammell, *International monetary policy*, p268. The relevant dates were 1931-9 (fixed exchange club), 1939-45 (economic warfare), 1945-50s (dollar defence)

¹⁹³ Kirshner, *Currency and coercion*, pp146-7

¹⁹⁴ Robertson and Singleton, 'The Commonwealth', p260

consistently. As summarised by Schenk, members would peg their currencies to sterling (the 'peg'), they would pool their hard currency reserves by selling them to the UK in return for sterling (the 'pool'), and they would operate national exchange controls in order to establish a ring of exchange control restricting the flow of hard currency in and out of the area (the 'controls').¹⁹⁵

What is less clear from the literature is how these rules worked in practice. It seemed that their country implementation was a bilateral question with the UK. Shonfield, citing South Africa's special position and political constraints on the colonies, stated:

'it is highly misleading to talk about the sterling area as if it were one simple and coherent body with a single set of rules obeyed equally by all comers'.¹⁹⁶

Grey, writing in 1952, thought the words 'rules' and 'area' were too formal for this free association of countries, 'who have each an interest in the well-being of others and who gain more by standing together than by standing alone'.¹⁹⁷ He stressed four working practices, holding working balances in London, pooling reserves, allowing fairly free intra-sterling area capital movements, and engaging in parallel devaluations (in 1949), but argued that there was little in the way of common policy or effective external control or discrimination, in contrast to contemporary American perceptions of the sterling area.¹⁹⁸ Extensive control was impossible in this loose association: 'the sterling area will break up rather than be governed by a tight rein'.¹⁹⁹

At the other extreme, citing secondary sources from the 1950s, Kirshner put forward the sterling area in the 1940s-50s as an example of both British extraction (by paying

¹⁹⁵ Schenk, *Britain*, p8

¹⁹⁶ Shonfield, *British economic policy*, p137

¹⁹⁷ Grey, 'The sterling area', p129

¹⁹⁸ Grey, 'The sterling area', pp127-30

¹⁹⁹ Grey, 'The sterling area', p134

war expenditure with sterling and then devaluing) and entrapment (interdependence restricting the reserve freedom of the RSA). He argued that the UK deliberately encouraged discrimination against the dollar, particularly among the countries which decolonised in this period.²⁰⁰ Symons' Treasury perspective revealed that the British officials had expectations of sterling area behaviour: sterling area countries were not supposed to acquire large non-sterling reserves, but those expectations were not always met. New Zealand, Nigeria, Jordan and Jamaica were firm holders for most of the period, Malaysia, Kuwait and Pakistan fairly steady. Libya, Iraq, Burma and Ceylon were poor holders, India reluctant, Australia initially loyal, but later independent and lacking confidence.²⁰¹

3.2.1 The sterling area and the sterling peg

Let us delve deeper into these three rules, beginning with the sterling peg. It is clear from the economic literature that pegging has important reserve management effects: pegging to sterling at narrower margins than the IMF's dollar peg would require sterling reserves for intervention purposes. The difficulty with the rule of the peg is one of measurement: in a world of fixed exchange rates, were sterling area countries truly committed to pegging to sterling, or was there some kind of implicit dollar pegging going on in the background? The sterling peg was not necessarily a hard peg: countries could and did adjust their sterling parities, just as they could under Bretton Woods rules with respect to the dollar and gold.

The sterling area's sterling pegging would only have been tested against the dollar if sterling had floated on the exchanges, which was seriously considered in 1952-5 but not acted upon. Fforde reported a Bank of England official's review of the first full

²⁰⁰ Kirshner, *Currency and coercion*, pp140-8, 167. 'British strength rested in the ability to release blocked balances, regulate and direct capital outflow, and manage and provide access to the gold and dollar pool' (p146)

²⁰¹ TNA:T267/29, 'Sterling balances', pp59-85

Commonwealth discussion about this plan in September 1952: 'the floating rate attracted considerable suspicion from all except the Canadians'.²⁰² Although initial concerns were allayed and Burnham presented this floating of the sterling exchange rate as a missed opportunity for the UK, it is interesting that in November-December 1952 India, Pakistan and Ceylon 'would not give a firm undertaking that they would maintain a de facto link with sterling (reserving the right instead to link to the dollar)' in the event of a float; and the UK Chancellor in turn considered 'pegging to the dollar incompatible with full membership of the sterling area'.²⁰³ These countries signed up to the December 1952 Commonwealth communique supporting the 'Collective Approach',²⁰⁴ but as Burnham and Fforde revealed, it was a compromise that gave the Asian countries an opt-out from sterling pegging if the day of floating ever came.²⁰⁵ In the 1960s, it seemed that pegging to sterling was not essential for membership of the sterling area. Schenk noted that Nigeria and Ghana moved their pegs away from sterling in 1962 and 1965 respectively, in 'a gradual disintegration of the sterling area by developed and developing members over the 1960s'.²⁰⁶

For clues about pegging, there were the 1949 and 1967 sterling devaluations, which have received wide coverage in the economic history literature.²⁰⁷ All sterling area countries except Pakistan matched the 1949 devaluation (30.5%), but most did not follow that in 1967 (14.3%).²⁰⁸ The logic of all moving together did linger in the 1950s and even the 1960s. In 1962, for instance, the economist Perkins was arguing that if all the sterling area countries devalued together, 'it would reduce the extent to which sterling would have to be devalued in order to secure a given effect upon the reserves'.²⁰⁹ Still, in considering Australia's possible response to a sterling devaluation

²⁰² Fforde, *Bank of England*, p478

²⁰³ Burnham, *Remaking*, p123

²⁰⁴ Aimed at achieving sterling convertibility, while preserving sterling stability

²⁰⁵ Burnham, *Remaking*, pp123-4; Fforde, *Bank of England*, pp483-4

²⁰⁶ Schenk, 'Monetary institutions', p195

²⁰⁷ Cairncross and Eichengreen, *Sterling in decline*

²⁰⁸ Ireland matched both devaluations but Australia did not devalue in 1967

²⁰⁹ Perkins, *Britain and Australia*, p157

or sterling floating in 1962, Perkins in fact argued that, against tradition, Australia might not devalue by the same amount or even at all.²¹⁰ In 1967, by contrast, it seems that the UK government did not want Australia, Malaysia, Hong Kong and Singapore to follow sterling's devaluation and asked Australia not to do so, fearing that others might follow their lead.²¹¹

So sterling pegging was a firmer rule in the 1950s. The preparations for Bretton Woods in 1942-4 also indicated that there were potential advantages for sterling pegging even under fixed exchange rates. There was alignment of sterling area countries with the UK in these negotiations. When the UK invited officials from Canada, Australia, India, New Zealand and South Africa to discuss Keynes's Clearing Union proposals at a London conference in October 1942, there appeared to be general agreement (except from the Bank of England) that the idea was good and should be tried out.²¹² In the Anglo-American negotiations, the UK's debates with the USA were strongly motivated by concerns about the international position of sterling and the sterling area.²¹³ The UK wanted its sterling balances to be settled between the UK and its creditors, not included in the scheme, and in the proposed convertibility provisions it sought reassurance that only new, not previous, accruals of currency would be made convertible. It stressed a larger, more accessible Fund and more freedom to alter parities and pursue domestic priorities.²¹⁴ It was thus concerned with the interests of debtors over creditors. Australia held even stronger views that creditors should be penalised, and also wanted more generous drawings and more domestic freedom to pursue full employment rather than focus so much on exchange stability and balance-of-payments stabilisation.²¹⁵ So although Bretton Woods was introducing an implicit dollar peg for all the IMF's members, there was a case, with adjustable parities, and

²¹⁰ Perkins, *Britain and Australia*, p159

²¹¹ Cairncross, *Managing*, p186

²¹² Muirhead, *Against the odds*, pp84-7

²¹³ Horsefield, *International Monetary Fund*, p52

²¹⁴ Horsefield, *International Monetary Fund*, pp53, 82-5, 104-5

²¹⁵ Muirhead, *Against the odds*, p317, n16; Horsefield, *International Monetary Fund*, pp82, 86, 94

priorities more aligned with the UK than with the USA, that the sterling peg remained most important for sterling area countries as they entered the post-war period. Certain ISA countries, Australia, Ireland and New Zealand, were slow to join the IMF.²¹⁶

3.2.2 The sterling area and controls

The secondary literature contains relatively little about the sterling area's (as opposed to the UK's) application of exchange and other controls. There seemed to be general agreement that controls were weaker in parts of the sterling area than in the UK.²¹⁷ So the question was whether this was a problem, and, if so, what could be done about it.

As earlier noted, membership of the wartime sterling area had seemingly been granted on the basis of assurances made to the UK about controls. Egypt was removed from the sterling area in July 1947, because its lack of controls over sterling payments made it impossible to ensure that Egypt's large post-war sterling reserves could be blocked.²¹⁸ So removal from the sterling area was a possible sanction for non-compliance. However, it is unclear what other penalties short of expulsion the UK authorities could have adopted if they were unhappy. The negotiations between the UK and sterling area countries over sterling area issues were primarily bilateral; the carrots and sticks of such negotiations reflected bilateral relations in the round.²¹⁹

Exchange control was a Bank of England specialism, and the post-war Bank did not have a positive view of controls, so it was understandable that it might have been

²¹⁶ Australia joined on 8/8/1947, Ireland on 8/8/1957, New Zealand on 31/8/1961 (Horsefield, *International Monetary Fund*, pp624, 628)

²¹⁷ Grey, 'The sterling area', pp128, 133; Schenk, 'Closing the Hong Kong', p337

²¹⁸ Fforde, *Bank of England*, pp117-20. There are other contradictory explanations for Egypt's departure, however: Pressnell, *External economic policy*, p366, and TNA:T267/29, 'Sterling balances', pp18-9, 34-6. The last claimed that the exit was Egypt's suggestion

²¹⁹ For negotiations between sterling area countries and the UK see Fforde, *Bank of England*, TNA:T267/29, 'Sterling balances'

tolerant of gaps in the sterling area's control.²²⁰ Moreover, from 1948 through the 1950s, most of the UK authorities' exchange control headaches were about 'cheap sterling', which concerned the NSA and its unofficial exchange markets (primarily the interplay between the transferable accounts area and the American account area), rather than, specifically, the sterling area.²²¹

Sterling area exchange control lacunae were also hard to eliminate and could even have positive effects. This was shown in Schenk's paper regarding the 'Hong Kong gap' in the 1950s. In Hong Kong and Kuwait, there were free exchange markets, which allowed UK residents to buy dollar securities with sterling. Schenk argued that this free market was of benefit to Hong Kong, supporting its exports and capital inflows, and since Hong Kong accrued sterling reserves, this was of net benefit to the sterling area. The gap also may have been helpful to the UK as a vent for large firms and relieving pressure arising from other restrictions. It was only when the dollar drain through this route became too large that the UK authorities, in July 1957, intervened by changing UK exchange control rules. The drain was also small relative to that from 'leads and lags' (advances and delays in the timing of trade settlements) which were not preventable by exchange controls, and some aspects of trade (e.g. invisibles) were not covered by UK exchange controls.²²²

Increasingly in the 1950s, the UK policy direction was also against import controls in the sterling area. In the 1952 'Collective Approach', the UK was pressing for the removal of quantitative restrictions while encouraging more discrimination against the NSA in the form of Commonwealth trade preference (lower tariffs within the Commonwealth than outside). This pressure was resisted by certain sterling area

²²⁰ Capie, *Bank of England*, pp172-3, 210-2

²²¹ Fforde, *Bank of England*, pp219-49. Cheap sterling markets were, however, 'assisted by devices whereby Sterling Area trade with the dollar area was disguised as trade within the non-dollar world' (Fforde, *Bank of England*, p221)

²²² Schenk, 'Closing the Hong Kong'

members such as India.²²³ As explained in Section 2, the positioning of Bretton Woods in relation to the monetary trilemma encouraged national capital and import controls in those countries which prioritised domestic development and were concerned about balance-of-payments deficits. In 1952-60, Australia stabilised its balance of payments through general import controls, including against the sterling area, which was not to the liking of UK policymakers.²²⁴ Thus, in the 1950s-60s, sterling area countries needed little additional incentive to operate capital and import controls, which also did not seem to be such a high priority for the UK. By 1960, Schenk argued, there was not much significance to the sterling area as a discriminatory co-operative arrangement.²²⁵

Nevertheless, while it is not particularly prominent in the sterling area literature, one can find there evidence of an important hard side to sterling area exchange controls. Due to exchange controls, all intra-sterling area trade settlement had to be in sterling area currencies, primarily sterling, and in practice there seemed to have been no uncontroversial exceptions to this rule.²²⁶ Within the sterling area, Egypt had had an 'obligation to accept sterling without limit for payment for exports or to provide Egyptian currency against sterling for UK expenditure inside Egypt'.²²⁷ When Burma demanded payment in dollars for rice sold to Ceylon in 1951, UK officials 'felt strongly enough about the Ceylon deal to consider Burma's expulsion'.²²⁸ In 1966, sterling was estimated to constitute 90 per cent of intra-sterling area trade; in 1967, trade between the sterling area and the NSA was thought to be 60 per cent in sterling, down from 70 per cent in 1964.²²⁹ These high percentages suggest a support mechanism for sterling trade settlement. In particular, currency of intra-sterling area trade settlement appears to have been a subject on which UK officials felt strongly and where RSA countries had limited discretion to be non-compliant.

²²³ Burnham, *Remaking*, pp119-23

²²⁴ Crawford, *Australian trade policy*, pp490-525

²²⁵ Schenk, *Britain*, pp129-30

²²⁶ Schenk, *The decline*, p209

²²⁷ Fforde, *Bank of England*, p118

²²⁸ TNA:T267/29, 'Sterling balances', p66

²²⁹ Schenk, *The decline*, p209

3.2.3 The sterling area and the pool

The pooling rule was that countries should sell all accruing gold and hard currency to the UK in return for sterling. While normally the rule was not written down, in the case of Libya, it was articulated in a secret 1951 exchange of letters setting out

‘the rights and duties of sterling area membership, including the right to draw on the Central Reserves for foreign currency commitments and the duty to pay into the reserves all US and Canadian dollars earned, and to limit drawings of these currencies in times of stringency to those required to meet essential needs.’²³⁰

Both contemporaries and historians recognised the economic rationale, during years of dollar scarcity, of these pooling arrangements in terms of risk-sharing, insurance and efficiency. Drawings on the pool were mitigated over time and space by other contributions, and supported countries’ emergency needs. The system allowed the sterling area as a whole to economise on its aggregate holdings of hard currency.²³¹

Recent literature has examined the strengths and weaknesses of regional reserve pooling. In the economic literature, the rationale for regional reserve pooling (as opposed to inter-regional reserve/credit arrangements such as the IMF) is sometimes questioned on risk diversification grounds, because country-level shocks are more correlated within than across regions. However, Basu, Bi and Kannan provided a theoretical argument that the extent of regional trade linkages was important since

²³⁰ TNA:T267/29, ‘Sterling balances’, pp72-3

²³¹ Meyer, *Britain, the sterling area*, pp92-4; Schenk, *Britain*, p11

responses to shocks have regional terms-of-trade effects which can only be fully internalised through a regional pool.²³²

There have also been empirical studies. In existing regional monetary unions, the Eastern Caribbean Currency Union and the CFA Franc Zone in West and Central Africa, pooling is achieved through a central banking/monetary arrangement for the region. Gains can be expressed in terms of a better coverage index (the ratio of average reserves to reserve variability) arising from the lower variability of pooled reserves compared to individual country reserves. Gains from pooling were shown to be significant in both cases. However, the outcomes for individual countries within the region were asymmetric (countries with ex-ante lower coverage gained more), and too-ready access to pooled reserves created fiscal and monetary indiscipline. The system also needed institutional governance that was both firm, with specified limits on credit access, and flexible, adjusting to shocks in the terms of trade.²³³

The 1997 Asian crisis and subsequent increase in Asian countries' international reserves prompted a debate about whether reserve pooling should be implemented there. Chang and Rajan examined the Japanese proposal for an Asian Monetary Fund (AMF). A regionally-pooled source of credit might provide funds more speedily, and with less conditionality, than the IMF. If crisis contagion is regional through interdependence, there is a regional interest in responding to it. They thought the main benefit would be in securing policy reform more effectively, by achieving regional consensus.²³⁴ Bird and Rajan argued that an AMF could provide a supplement to the IMF: a framework for regional financial co-operation covering domestic financial systems, exchange rate policies and short-term contingency lending.²³⁵ According to Rajan, regional arrangements to provide liquidity in response to regional crises would

²³² Basu, Bi and Kannan, 'Regional reserve pooling'

²³³ Williams, Polius and Hazel, 'Reserve pooling'

²³⁴ Chang and Rajan, 'The economics and politics'

²³⁵ Bird and Rajan, 'The evolving Asian'

have more of the features of a credit union than the IMF possesses: all countries would be more strongly motivated to ensure its success. He also said that prudential and supervisory standards are more appropriately set at the regional level.²³⁶ Still, the case for reserve pooling in Asia was not overwhelming. While analysis based largely on reserves/imports showed significant excess reserves in aggregate, creating savings via pooling,²³⁷ coverage index analysis suggested smaller aggregate savings, and these were asymmetrically distributed, with some countries gaining little or nothing. Given the Asian countries' focus on owned reserves and exchange rate independence, achieving regional monetary co-operation would face political obstacles and the Chang Mai Initiative (CMI) for Asian central bank currency swaps was a natural first step.²³⁸

In considering the relevance of this recent literature, it should be noted that the sterling area was not a region, but it was linked by trade, particularly bilateral trade with the UK.²³⁹ One of the main benefits of the system was supposed to be the complementary balance between UK manufacturing and RSA primary production, internalising shocks to the terms of trade between these types of goods.²⁴⁰

The sterling area was also not a credit union – no country could rely on receiving credit from the UK – nor was it a monetary union. Countries could only draw on the dollar pool to the extent of their owned sterling reserves. In the latter respect of a limit based on contributions, the mechanism was closest to that of the East Caribbean arrangement, which also had this feature. But the East Caribbean Central Bank held more foreign assets than could be drawn by the members, while the RSA's sterling reserves were a multiple of the dollar pool (see below). Unlike in a monetary union, these sterling reserves also enjoyed international acceptability beyond their value as

²³⁶ Rajan, 'Unilateral, regional'

²³⁷ Rajan, Siregar and Bird, 'Examining the case'; Wan and Chee, 'Macroeconomic considerations'

²³⁸ Rajan, Siregar and Bird, 'Examining the case'

²³⁹ Schenk, *Britain*, pp55-9

²⁴⁰ Meyer, *Britain, the sterling area*, pp62-70

the 'domestic' token that could be exchanged with the central authority – an important distinction which became the source of analytical controversy for the sterling area (see Wright versus Kamarck below). Despite these differences, the questions of asymmetric gains/losses, governance and co-operation were clearly important issues for the sterling area.

In 1954 Wright attempted to analyse the working of the sterling area's dollar pooling at a country and aggregate level during 1939-52. He argued that pooling, while informal and flexible, consisted of three principles: national mobilisation of hard currency into each central authority, the sale to the UK for sterling of all new accruals of hard currency (above a base level) and import-licensing control of dollar imports which initially was limited to 'essential' imports. However, such import claims of need, together with the 'moral claims' of countries which had contributed to the pool, led to excess pressure on the pool. In terms of contributions to and drawings on the dollar pool, Wright argued that the UK and colonies had in effect passed significant international dollar aid and colonial surpluses to the ISA, making the colonies big losers and the ISA big gainers.²⁴¹ The calculus of country gainers and losers was extended by Bhagat for 1945-58, with a broadly similar conclusion.²⁴² Wright also referred to possible effects of 'dollar-saving' intra-sterling area exports, arguing that these increased sterling area trade at the expense of trade with the dollar area; and to the dollar-economising effect of reserve pooling, which freed up dollars for expenditure on more dollar imports.²⁴³

Wright's article drew a strong critique from Greaves (in relation to the colonies) and more generally from Kamarck.²⁴⁴ There were several strands to their criticisms, but

²⁴¹ Wright, 'Dollar pooling'

²⁴² Bhagat, 'Working'. Bhagat showed that Australia drew heavily on the dollar pool in 1950-8, but had an even larger surplus with the OEEC countries of Europe. Ireland was a small drawer on the dollar pool, and had a sizeable deficit with the OEEC

²⁴³ Wright, 'Dollar pooling'

²⁴⁴ Greaves, 'Pooling: comment'; Kamarck, 'Pooling: comment'

most important was that Wright's analysis, by focusing only on and deriving normative conclusions from drawings on the dollar pool, was simplistic and incomplete. Kamarck found discussion of 'dollar-saving' exports similarly misleading and unnecessary. Rather, since spending sterling in the NDNSA (then a large source of external deficit for the sterling area) and in the UK could also cause, indirectly, a loss of dollars from the reserves, he argued,

'in assessing the contribution made by a sterling-area country to the dollar position of the whole area, it is necessary to consider not only its dollar accounts but its global balance of payments'.²⁴⁵

Wright, in response, tried to defend his claim of effective, if not deliberate, colonial exploitation vis-à-vis Greaves. With Kamarck he agreed that, under convertibility, each country's global balance of payments became important to the analysis, but defended his 'lopsided' treatment for the years of sterling inconvertibility, which he said covered most of the 1939-52 years. He also queried how to judge between the dollar and the global payments analyses if they led to different conclusions.²⁴⁶

Wright's broad agreement with Kamarck over the correct analysis under convertibility suggests that, in 1955, when de facto convertibility had already been achieved and the problem of dollar scarcity was disappearing, the dollar pool drawings analysis was already at best incomplete (sterling was not just a domestic token of no international value), and certainly so when Bhagat was writing. Still, such analysis inevitably suggested conflicts between perceived contributors and drawers, as well as, through these debates, controversy over the measurement of contributions and drawings. Symons argued that countries which derived no benefit from membership of the sterling area (he listed Kuwait, other Persian Gulf states, Libya, Iraq, Burma and

²⁴⁵ Kamarck, 'Pooling: comment', p653

²⁴⁶ Wright, 'Pooling: reply'

Ceylon) usually became poor holders of sterling; their diversification set a bad example for others; and excluding them from the area was problematic because of the effect on confidence.²⁴⁷

According to Zupnick, dollar pooling also had serious macroeconomic effects on the sterling area. Lacking discipline and a co-ordination mechanism, it was inflationary and led to a misallocation of resources. The inflation arose because the ISA could draw freely on the dollar pool in order to industrialise, generating inflation in the ISA, and this expenditure also drew forth complementary, 'unrequited exports'²⁴⁸ from the UK, creating more inflation there too. The misallocation arose from uncontrolled drawings on the pool, unbalanced drawing (restraint by the UK and colonies, but not the ISA) and emergency action taken during sterling crises causing projects to be abandoned following an intensification of import controls.²⁴⁹

3.2.4 Rules: sterling area attitudes after the restoration of convertibility

It is clear from the above discussions that convertibility was of great significance for the sterling area. In respect of the pool, Zupnick highlighted the differences between the 'sterling bloc' (convertibility) and 'sterling area' (inconvertibility) periods. In the latter period, sterling area countries were 'obliged' to sell their hard currency earnings to London; there was 'implicit discrimination' against hard currency goods and in favour of sterling goods; and

²⁴⁷ TNA:T267/29, 'Sterling balances', p97

²⁴⁸ 'Unrequited exports' was language referencing that British exports to the RSA did not earn hard currency or match corresponding imports, but merely reduced a sterling monetary obligation

²⁴⁹ Zupnick, 'The sterling area's'. Also Shonfield's related criticisms below

‘sterling area countries were expected to frame their relevant economic policies in the light of the state of the central reserves rather than with reference to the state of their individual sterling reserves’.²⁵⁰

When did all this come to an end? According to Schenk, the sterling crisis of 1952 was the ‘last gasp of strictly coordinated sterling area policy’ and from this year, when the sterling area endorsed the ‘Collective Approach’ to freer trade and payments, ‘trade discrimination was abandoned by successive members’.²⁵¹ This view was also expressed by Symons, who stated that, after 1952, ‘the policies of individual countries became related to their own reserves position and not to that of the Central Reserves’.²⁵²

The attitudes of leading financial commentators on the post-convertibility sterling area were revealed in 1959 in a discussion in the Oxford Bulletin of Statistics about the area’s future policy direction. The organiser, Scott, contrasted the then status quo with three recent radical proposals emanating from within the UK, and sought external responses. First was the idea of ‘Britain alone’, represented by the writers Day and Shonfield. In response to frequent sterling crises, they were proposing blocking, funding or guaranteeing the RSA’s sterling reserves, imposing exchange controls against the sterling area and restricting UK current and capital spending there, effectively bringing the sterling area to an end. Another idea, ‘One world with flexible exchange rates’, supported by Meade and Scammell (and also favoured by Scott), was that the UK should, while continuing to reduce barriers to trade, engage in managed floating of its exchange rate. Sterling area countries might be persuaded to accept this by the offer of dollar guarantees for official holdings, and, in the view of Meade, should introduce flexible rates for their own currencies. A third idea, ‘The Club’, associated

²⁵⁰ Zupnick, ‘The sterling area’s’, p73

²⁵¹ Schenk, *Britain*, p15

²⁵² TNA:T267/29, ‘Sterling balances’, p98

with Amery, Balogh and Sargent, proposed increasing the discrimination between members and non-members, including the possible reversal of convertibility for the NSA.²⁵³ Various responses came from well-informed commentators in ten countries/regions.²⁵⁴ It is hard to encapsulate all these responses (Scott provided a summary),²⁵⁵ but, in short, the RSA view on 'Britain alone' was outright hostile and retaliatory, the view on floating was mainly hostile, and the view on 'The Club' was mixed, at best. Australia, New Zealand and possibly Ghana would only welcome the club if it included Europe, while India, Iraq, South Africa and Ireland did not welcome it. Most writers favoured the status quo, which was seen as generally beneficial to the RSA countries in terms of its mix of freedom, capital inflow, trade preferences and access to the UK market.²⁵⁶ Iraq clearly found sterling area membership too constraining. It sought monetary and exchange rate independence, and resented the historic blocking of its sterling reserves, the 1949 devaluation and, in particular, the constraints of its past currency board.²⁵⁷ At the other extreme, the Indian correspondent expressed indifference, instead stressing India's insufficient reserves and reliance on American and IMF/World Bank capital.²⁵⁸

These writers may not have been wholly representative of policy or wider opinion, but, to the extent that they were, one can infer that, in 1959, there was a sterling area commitment to the rule of the sterling peg, but it was contingent on sterling not being devalued or floating against the dollar (the Australians wanted a dollar guarantee). There seemed to be little commitment to sterling area discrimination against the NSA (Australia, India, New Zealand and Pakistan had all imposed restrictions on UK and

²⁵³ Scott, 'What should be done?'

²⁵⁴ Downing and Perkins, 'Australia'; Ady, 'Ghana'; Datta, 'India'; Shehab, 'Iraq'; Duncan, 'The Irish Republic'; Simkin, 'New Zealand'; Barback, 'Nigeria'; Faber, 'The Federation'; De V. Graaf, 'The Union'; Analyst, 'The West Indies'

²⁵⁵ Scott, 'Conclusion'

²⁵⁶ Schenk investigated these three policy alternatives in the 1950s and the reaction of the RSA, similarly concluding that 'the chosen path of a gradual administrative approach to freer trade and payments was preferable to the alternatives' (Schenk, 'The sterling area', p266)

²⁵⁷ Shehab, 'Iraq'

²⁵⁸ Datta, 'India'

sterling area goods).²⁵⁹ And there was no obvious sterling area policy co-ordination. The unanswered question is the extent to which sterling area countries still felt 'obliged' to sell their dollars and gold to the UK in return for sterling, or whether their pooling of reserves was, as under the sterling bloc, now entirely voluntary (which Wright had predicted would be the case with convertibility).²⁶⁰ The diversification of sterling area countries' reserves is covered with the 'sterling balances' below.

3.2.5 The sterling area and co-operation/consultation

Before turning to the sterling balances, let us consider an additional rule for the sterling area: that of co-operation, both overall, and over and beyond the informal rules of the peg, controls and pool. As a co-operative system, the sterling area was located within the field of international finance, in the relations of governments and central banks. Co-operative institutions such as the British Commonwealth (political) and Commonwealth trade preference (trade) were closely related but separate matters.

As we saw, Zupnick alluded to economic policy co-ordination as a key distinguishing feature of the sterling area, while Schenk noted that co-ordinated trade policy ended in 1952. Symons criticised the one-sidedness of the system i.e. its core-periphery structure: the UK's bilateral approach did not engender a sense of partnership. The 1949 conference to agree dollar economies was a high point in co-operation, but, after 1952, consultation between members was 'not as comprehensive as had been envisaged' and the 'club spirit' waned.²⁶¹

The contemporary economist Day in 1954 presented the sterling area as a bargain structured around convenience, stability and discrimination. The last was in Britain's

²⁵⁹ Scott, 'What should be done', p215

²⁶⁰ Wright, 'Dollar pooling', p576

²⁶¹ TNA:T267/29, 'Sterling balances', p98

favour, allowing a higher standard of living than would have prevailed in its absence, while the first two favoured the RSA. In essence, the bargain was the export of British capital in return for discrimination: however, he said that the costs for the UK of maintaining the arrangement were high and increasing, as colonies became independent, independent countries industrialised and the focus on development increased.²⁶² Bell similarly considered the sterling area's declining cohesion.²⁶³ The American academic, Polk, saw the lack of co-ordination as a weakness of the system, but thought its club culture, in which countries helped each other out, was a source of strength.²⁶⁴

Other more recent authors, such as Cooper and Singleton, described the sterling area as a highly co-operative system, aiming to protect sterling's value and the reserves of the sterling area as a whole, although Singleton observed that interest in the sterling area waned in the 1960s.²⁶⁵ Cassels similarly in 1951 was upbeat about consultation, referring to the strengthening of collaborative ties between sterling area central banks after the war, and describing the setting up in 1947-8 of two London-based consultative committees of sterling area representatives, the Sterling Area Statistical Committee and the Commonwealth Liaison Committee. He argued that these acted as a 'permanent secretariat for the meetings of the Commonwealth Finance Ministers at which all major questions of Sterling Area policy now receive consideration'.²⁶⁶

None of these descriptions are necessarily contradictory – they were made at different times and addressed different things – but they do suggest a wide variety of emphases in the literature about the sterling area, from highly co-operative to displaying little co-operation.

²⁶² Day, *The future*

²⁶³ Bell, *The sterling area*

²⁶⁴ Polk, *Sterling*, pp232-45

²⁶⁵ Cooper, 'Almost a century', p86; Singleton, *Central banking*, p181

²⁶⁶ Cassels, *The sterling area*, p29

3.2.6 The RSA's expectations of the UK

Finally, when discussing the tacit rules of the sterling area, the RSA had expectations of the UK. Firstly, there were the exchange control exemptions which defined the sterling area, in particular the importance of UK capital flow. When the British government tried to limit this, for example through the above-mentioned 1966 Voluntary Programme, there was a negative reaction. Thus the economist Perkins, generally favourable to the sterling area system, wrote in 1968:

‘in the past the risks run by Australia in holding sterling may have been a reasonable price to pay for relatively free access to British capital. But if this favourable treatment continues to be eroded, Australia might well reduce correspondingly the amount she is prepared to risk in unguaranteed reserves’.²⁶⁷

Secondly, as shown in the Libyan exchange of letters, a counterpart to reserve pooling was that the Bank of England should not refuse RSA requests for hard currency in exchange for their sterling, ensuring sterling convertibility at all times for members of the sterling area, unless otherwise by agreement.

Above all, the UK should act to preserve sterling's value against the US dollar. Indeed, to the extent that the UK was successful in this, RSA countries had little to fear from using sterling as their principal reserve. Schenk noted that Britain's (modest) 1967 devaluation produced ‘a profound sense of betrayal’ among RSA countries.²⁶⁸

²⁶⁷ Perkins, ‘Australia and the 1967’, p11

²⁶⁸ Schenk, *The decline*, p313

How seriously did the UK take these obligations? Schenk argued that the sterling area did not constrain British policy in the 1950s,²⁶⁹ and that from the early 1960s British policymakers aimed to retire sterling's international role.²⁷⁰ However Brittan, a well-informed journalist and civil servant, wrote in 1971 that 'the most important drawback' of sterling's reserve currency role 'was that it greatly strengthened official inhibitions against devaluation'.²⁷¹ Capie also noted that the Bank of England, where there was 'greater concern than elsewhere for the holders of sterling'²⁷² engaged in market support for the currency in 1964-7 on a 'huge scale with close to total freedom'.²⁷³ Through its actions the Bank delayed devaluation, and two leading officials with responsibility for sterling's international position, Parsons and Bridge, who had led the defence of sterling, left the Bank soon after devaluation.²⁷⁴ Oliver and Hamilton showed that even after devaluation the Bank continued to give high priority to the maintenance of the sterling area.²⁷⁵

3.3 The sterling area and the 'sterling balances'

Much of the debate about the sterling area in the 1950s-60s has concerned the 'problem of the sterling balances' arising from the scale of the UK's monetary obligations following the war. Fforde said this problem had three dimensions. The first dimension, the most urgent, was the 'release of wartime accumulations'. The second was 'the volatility of untied balances and the ratio of UK reserves to external monetary liabilities'. The third, the most long-term, was diversification, being the accumulation of separate reserves of gold or dollars by RSA countries.²⁷⁶

²⁶⁹ Schenk, *Britain*, pp113-28

²⁷⁰ Schenk, *The decline*, pp117, 422-5

²⁷¹ Brittan, *Steering the economy*, p446

²⁷² Capie, *Bank of England*, p249

²⁷³ Capie, *Bank of England*, p245

²⁷⁴ Capie, *Bank of England*, pp247-8

²⁷⁵ Oliver and Hamilton, 'Downhill from devaluation'

²⁷⁶ Fforde, *Bank of England*, p275

The sterling balances problem covered both RSA and NSA countries. Table 4 provides an overview of their sterling reserves (the UK's net external liabilities²⁷⁷ in sterling) in 1949-69, set against UK official reserves of gold and convertible currency. It is just a snapshot on three dates based on public data: there was significant variation of individual countries' holdings within these groups and from year to year. The main features to observe are the scale of the sterling obligations relative to reserves, and the varying geographic distribution of the RSA holdings, some increasing and some decreasing over time.

£m	1949	1959	1969
Sterling area country groups:			
Australia, New Zealand and South Africa	463	463	230
India, Pakistan and Ceylon	774	254	212
Caribbean Area	65	112	184
East, Central and West Africa	336	628	293
Middle East	8	338	388
Far East	195	592	794
Other	280	304	428
Total sterling area countries	2107	2691	2529
Total non-sterling area countries	986	682	763
Total international organisations - non-sterling area	576	705	2123
Total sterling balances – world	3669	4078	5415
UK official reserves of gold and convertible currency	603	977	1053

Table 4: Sterling balances, by country groups, compared with UK official reserves, as at end of December, 1949, 1959 and 1969 (£m)

Source: BOE:Statistical Abstract No.1, Table 21, pp125-7, Table 22(1), p131, Table 22(4), pp142-3 and Table 27, pp162-3

Note: Sterling balances = net external liabilities of the UK in sterling

3.3.1 The wartime accumulations and associated political/economic problems

The wartime accumulations dimension was associated particularly with the large blocked sterling holdings of pre-partition India and Egypt. Egypt had been removed from the sterling area, and, at £774m, the sterling holdings of India, Pakistan and Ceylon in 1949 were already £578m less than they had been at the end of 1945.²⁷⁸

²⁷⁷ Although for convenience this phrase is used throughout the dissertation, the definition was technical and excluded certain illiquid assets/liabilities, see the crises paper

²⁷⁸ BOE:Statistical Abstract No.1, Table 21, p125

Moreover, between 1950 and 1952, 'the geographical distribution of the sterling balances shifted dramatically from the independent wartime holders to new colonial holdings'.²⁷⁹ During the rest of the 1950s the holdings in the Indian region were further recycled into firmer hands.²⁸⁰

So the wartime accumulations were on the way to resolution by 1950. Still, the spending of such reserves could have negative macroeconomic consequences. Grey in 1952 argued that, alongside the UK's previous cheap money policy (which admittedly ended that year), and the UK's capital exports to the RSA, the too rapid drawing down of the sterling balances, generating unrequited exports from the UK, had inflationary consequences throughout the sterling area.²⁸¹

The UK's negotiations with wartime creditors could also be the source of longer-term political problems. De Paiva Abreu made a focus of the UK's difficult negotiations, both during the war and shortly afterwards, with wartime creditors, Brazil, Portugal and India.²⁸² De P. Abreu argued that in each case, the agreements, relating to blocking, exchange guarantees or trade commitments, favoured the UK. In the case of Brazil, the Brazilian policymakers negotiated badly, allowing too much sterling to be blocked and not optimising the guarantees negotiated with the British.²⁸³ Portugal, seeking wartime protection against Spain and post-war legitimacy for the Salazar regime and Portuguese Empire, sold valuable war goods to the UK on credit, and later agreed to a long-term loan to the UK.²⁸⁴ India had a weak bargaining hand: an incomplete wartime agreement led to a huge expansion of sterling balances, and exchange guarantees were refused by the UK because India was part of the sterling area (on the grounds that, if sterling were to be devalued, the rupee would be expected to follow). Low

²⁷⁹ Schenk, *Britain*, p15

²⁸⁰ Schenk, *Britain*, pp17-27

²⁸¹ Grey, 'The sterling area', p131

²⁸² India was the only sterling area member

²⁸³ De P. Abreu, 'Brazil'

²⁸⁴ De P. Abreu, 'A 'blank cheque'?'

interest rates, constrained releases of sterling balances (delaying imports), and the devaluation of 1949 proved costly for India.²⁸⁵ De P. Abreu's method involved an ex-post calculation of gains and losses: perhaps not surprisingly, given the 1949 devaluation, the UK was recorded as the 'winner' of these negotiations. If so, it may have been a hollow victory. Symons argued that the UK's harsh treatment of India, Egypt and other such creditors led to distrust in sterling by these countries, contributing to difficulties faced in the 1960s.²⁸⁶

Another big spender of sterling in the late 1940s was South Africa. Relations between the UK and South Africa were a complicated mixture of economics and politics, but here the sides were more evenly matched. Rooth's 1945-50 study showed how, while the pro-UK United Party governed in South Africa, South Africa's bargaining position against the UK was strong and it spent heavily in the dollar area during the 1947 sterling convertibility crisis, after which South Africa was excluded from automatic access to the dollar pool. Following the election of a Nationalist government in May 1948, South Africa's reserve position was weak and it weakened further with capital outflows, forcing this anti-UK government to be more pragmatic and make an agreement with the UK about selling gold production through London. Rooth went so far as to call this process a 'recolonisation'.²⁸⁷ Henshaw's 1931-61 study showed how, despite political differences, the strong mutual economic dependence of the UK and South Africa kept the latter in the sterling bloc/area between 1933 and 1972. South Africa was reliant on British capital investment in gold production, and on the British market for sales of fruit and jam. For the UK, South Africa's status as the world's dominant gold producer made its post-1947 membership of the sterling area (despite no longer being part of the dollar pool or retaining large amounts of sterling) a matter of symbolic importance for the apparent strength of the area. The mutual economic

²⁸⁵ De P. Abreu, 'Britain as a debtor'

²⁸⁶ TNA:T267/29, 'Sterling balances', pp95-8

²⁸⁷ Rooth, 'Britain, South African gold'. The quotation from p110

dependence meant that each side could take different political paths without threatening the economic relationship. By the end of the 1950s, South Africa had attained a more economically insulated position.²⁸⁸

3.3.2 Volatility of the untied sterling balances, and the balances/reserves ratio

It was Fforde's second dimension that arguably attracted the most debate in the literature. There was much contemporary focus on the sterling balances/reserves ratio which seemed to pose a threat to sterling. Shonfield, attacking the official narrative for the sterling area, claimed that, in order to prevent this overhang from collapsing – he described it, as it was often described, as a banking arrangement and the risk, that of a run on the bank – the UK had entered into a 'hard bargain' with RSA countries, giving them automatic access to the dollar pool, and preferential access to British capital investment.²⁸⁹ The result was high investment and balance-of-payments deficits in the RSA, financed by the UK.²⁹⁰ Moreover, UK investment into Australia and Rhodesia 'does not help West Africa or Malaya or India in any way to conserve their sterling balances'.²⁹¹ He referenced India's spending under its second Five-Year Plan in 1956-7 and noted that, when the UK refused a £200m loan to India in 1957, the Indian response was to reduce the sterling backing for the Indian currency and spend the sterling thereby saved. Since the Indian Finance Minister had also said that India was prepared to spend all its sterling to meet essential imports, Shonfield claimed that this showed that even sterling balances purported by UK officials to be illiquid could be liquefied and spent.²⁹²

²⁸⁸ Henshaw, 'Britain, South Africa'

²⁸⁹ Shonfield, *British economic policy*, p125

²⁹⁰ Shonfield, *British economic policy*, pp128-9, 134. Other critics of the sterling area, notably Canadian commentators in the 1950s and French policymakers in the 1960s, argued that the scale of RSA deficits sometimes destabilised sterling. (For Canadian views, see Fullerton, *Graham Towers*, p222; Muirhead, *The development*, pp76-107; Moggridge, *Harry Johnson*, pp112-3. For French criticisms, see Schenk, *The decline*, pp126, 134-7)

²⁹¹ Shonfield, *British economic policy*, p132

²⁹² Shonfield, *British economic policy*, p131

Writing in the 1990s, Schenk took an opposing view, arguing that the fragility of sterling arising from the overhang of sterling balances relative to inadequate reserves had been exaggerated.²⁹³ Addressing this 'spurious'²⁹⁴ ratio, which was of long standing – operating as an international banker on thin reserves²⁹⁵ – Schenk showed that, once additional assets such as IMF reserves and an unpublicised large equity portfolio were included in reserves, the ratio of net sterling liabilities to UK reserves was stable, at less than 3:1, from around 1950.²⁹⁶ In other words, for sterling there was no Triffin dynamic of a deteriorating ratio. This was a 'banker to the sterling area' stability argument for sterling. In support of Schenk's argument, while contemporaries and historians might have talked about a threat of a confidence-driven run on the bank by the RSA,²⁹⁷ there was little evidence provided for it until 1964.²⁹⁸

Schenk's second argument about this ratio was based on the sterling area's balance of payments in the 1950s. According to Schenk, the RSA, being generally in surplus (after including the long-term capital account) with the NSA, was implicitly contributing to the reserves of the sterling area system, and so could only be improving the ratio of sterling balances/reserves.²⁹⁹ These different views of the sterling area's balance of payments (Shonfield's and Schenk's) echo the dispute between Kamarck and Wright about countries' contributions to the dollar pool. Scott presented the 1950s payment flows in a different way from Schenk and it is informative for the context to compare these figures (Table 5). Scott, who did not consider 'necessarily deplorable'³⁰⁰ the fact that the sterling balances exceeded the reserves, and who deliberately chose not to

²⁹³ Schenk, *Britain*, p18

²⁹⁴ Schenk, *Britain*, p35

²⁹⁵ Schenk, *Britain*, p18

²⁹⁶ Schenk, *The decline*, pp86-7. Shonfield was aware of the equity portfolio (Shonfield, *British economic policy*, p284)

²⁹⁷ Collins and Eichengreen, reviewing Schenk, *Britain*, argued that the denial of confidence effects from the sterling balances was overdone: Eichengreen suggested that sterling area controls were preventing a run on the balances (Collins, 'Reviewed work', p412; Eichengreen, 'Reviewed work', p941)

²⁹⁸ Newton noted that £80m of RSA confidence-driven outflows from sterling in 1964 was 'an unprecedented development' (Newton, 'The 1949 sterling crisis', p92)

²⁹⁹ Schenk, *Britain*, pp28-9

³⁰⁰ Scott, 'What should be done', p218

present the RSA's balance of payments only in relation to dollars and gold, also warned against the dangers of identifying accounting analyses with causal analyses.³⁰¹

£m	RSA 'overall' surplus or deficit (Scott)	RSA balance with NSA (Schenk)
1950	+183	+466
1951	-78	+242
1952	-166	+182
1953	+145	+297
1954	-93	+174
1955	-71	+143
1956	-141	+159
1957	-256	+125

Table 5: RSA balance of payments – two alternative versions, 1950 – 1957 (£m)

Source: Extracted from Schenk, *Britain*, p28, Table 2.2; and Scott, 'What should be done', p220, Table 2

Note: RSA = Rest of the sterling area

Schenk's argument addressed contemporaries' flawed focus on the sterling balances/reserves ratio as a direct source of weakness, but the key question for debate was the stability of the sterling balances and the effect of any volatility on the UK's reserves: the kinetic forces affecting reserves rather than the potential risk from the stock of liabilities. Here Schenk concluded:

'The sterling balances were remarkably stable throughout the 1950s (and most of the 1960s) and this was not due to convenient coincidence but rather to the deliberate functioning of the sterling area itself. In this sense the conclusion that the balances were relatively stable is not merely an *ex post* observation'.³⁰²

The argument was that, before and during the 1950s, wartime accumulations of sterling were passed into firmer hands. Moreover, the diversity of sterling area countries ensured that aggregate movements in balances were dampened, while many colonial (and other) balances were held in illiquid forms, such as currency boards. As

³⁰¹ Scott, 'What should be done', p219

³⁰² Schenk, *Britain*, p18

for the ISA, after the mid-1950s, 'most countries held only minimal working balances'.³⁰³ The Shonfield and Schenk accounts are thus contradictory regarding the liquidity (and variation)³⁰⁴ of the sterling balances.

3.3.3 Diversification from sterling into dollars and gold

To summarise, reducing sterling reserves by spending them on goods and services (incurring overall balance-of-payments deficits) was not against the rules of the sterling area. In aggregate, some economy needed to be exercised in order to preserve the central reserves, but after 1952, the central reserves ceased to be a focus of policy co-ordination for the RSA. By contrast, Fforde's third dimension, selling sterling for dollars in order to hold those dollars, was a breach of the British pooling rule and was taken seriously by British policymakers. This is shown by Symons's memorandum, which, when talking about the RSA official holdings in the 1950s-60s, addressed almost entirely the issue of these countries' changing attitudes to independent gold and dollar reserves. He focused on 14 countries, a mixture of independents, and colonies which became independent during the period. The countries covered were: Australia, New Zealand, Pakistan, Iraq, Burma, Ceylon, India, Libya, Malaysia, Kuwait, Nigeria, Jordan, Zambia and Jamaica. Ireland and South Africa, being 'special cases', were not discussed in detail.³⁰⁵ Of these, the largest cumulative additions to non-sterling reserves initially came from Australia, which stopped selling its gold production to the UK in 1951, and India, which from 1948 increased the dollars held at its Indian Supply Mission in Washington.³⁰⁶

³⁰³ Schenk, *Britain*, pp17-27

³⁰⁴ Shonfield, *British economic policy*, pp85-7

³⁰⁵ TNA:T267/29, 'Sterling balances', pp59-91

³⁰⁶ TNA:T267/29, 'Sterling balances', p86

Symons said that this diversification in the form of many 'requests' to the UK for more gold and dollar holdings was reflected in sterling's share of each country's reserves.³⁰⁷ Understandably, the focus on 'sterling's share' as a barometer of 'diversification' has been taken up by the historical literature. Schenk calculated sterling's (declining) share for seven ISA countries in 1950-8 and observed:

'during the 1950s most independent members of the sterling area that had control of the denomination of their reserves did diversify from the high levels of sterling that they had held at the start of the decade, mainly by spending their sterling on British goods while they held their US dollar assets and gold constant'.³⁰⁸

Schenk's statement reveals that 'sterling's share' as a statistic conflated two issues, one, the spending of sterling on goods and services, and two, switching from sterling into dollars or gold. The latter, though cumulative in effect, was not particularly large in the RSA in the 1950s, as Schenk highlighted. The former, though it could be large, was not necessarily irreversible or in the immediate control of policymakers, but reflected the cyclical balance of payments of a country. Indeed 'diversification' itself is an ambiguous term which could refer to the combined effect (as in the quotation above) or only to the switching out of sterling, as when Schenk wrote that 'diversification would disrupt the entire sterling system'.³⁰⁹ In analysing reserve management in the sterling area system, there is a need to separate out these different moving parts, which means largely abandoning 'sterling's share' as an analytical tool.

³⁰⁷ TNA:T267/29, 'Sterling balances', p59

³⁰⁸ Schenk, *The decline*, p89

³⁰⁹ Schenk, *The decline*, p89

'Sterling's share' did, however, become the policy instrument by which the UK government stabilised the RSA's official sterling holdings after the devaluation of 1967. The Basle and Sterling Agreements of 1968 combined NSA support to the UK, with RSA promises to hold minimum sterling proportions of their reserves, and a UK guarantee to the RSA of sterling's dollar value, changing the whole nature of the sterling area.³¹⁰ The bilateral Sterling Agreements, called Minimum Sterling Proportion (MSP) Agreements, continued until 1974. Schenk described their significance as follows:

'The reserve role of sterling thus became formalised and negotiated, rather than voluntary and based primarily on market portfolio decisions'.³¹¹

One can also find the issues of switching and spending in the literature about post-war sterling crises (the crisis episodes in 1945-67 being 1947, 1949, 1951-2, 1955, 1956, 1957, 1961, 1964, 1965, 1966, 1967). Hirsch, a contemporary journalist trying to categorise these crises, highlighted three types of problem. One was British balance-of-payments deficits. Another was straight speculation, which encompassed countries switching sterling into dollars for confidence reasons. A third was 'conversion': 'overseas sterling countries and others using their London funds to meet their own payment deficits'.³¹² But Conan combined RSA spending and switching: he distinguished 'current balance' crises (driven by the UK current account) from 'reserves' crises (everything else).³¹³ Although some crises were associated partly with British payments deficits, each author gave a large role to the speculative/reserves factors. Conan likened the UK's problem to that of the USA as a reserve currency issuer:

³¹⁰ Schenk, *The decline*, pp273-316

³¹¹ Schenk, *The decline*, p313

³¹² Hirsch, *The pound sterling*, p47

³¹³ Conan, *The problem*, pp18-19

‘For each country the problem is not merely to live within its income but to earn enough to meet commitments which are incurred largely on behalf of others’.³¹⁴

Interestingly, in Hirsch’s judgement, the problem of ‘conversion’ (RSA deficits) featured in only the 1947 and 1951-2 crises, alongside other factors.³¹⁵ And in the more recent historical literature, the focus has tended to be either on British balance-of-payments deficits (or underlying domestic drivers such as fiscal deficits or wage inflation), or straight speculation. These two explanations correspond to the currency crisis literature,³¹⁶ which has informed the work of economic historians. In ‘first generation’ models from the 1970s-80s, governments are on a doomed, inconsistent policy path, and the timing of speculative attack is predicted based on the level of a ‘shadow exchange rate’.³¹⁷ In ‘second generation’ models of the 1990s, changes in government behaviour, switching between monetary regimes, and shifts in expectations, can result in multiple equilibria. In debating the 1964-7 crisis period, Newton defended British policy and blamed speculative international capital flows (a second generation model explanation) while Oliver highlighted British policy failure (a first generation model explanation).³¹⁸ When turning to the specific role of the ISA countries in sterling crises, again the recent literature has focused almost wholly on confidence and speculation (response to Britain’s economic weakness), rather than ‘conversion’ and RSA deficits. Both Newton and Oliver largely addressed the former in their further debates about the 1960s.³¹⁹ Thus it seems that, despite Shonfield’s claims about RSA deficits, economic

³¹⁴ Conan, *The problem*, p113

³¹⁵ Hirsch, *The pound sterling*, pp48-9. Hirsch also mentioned conversion in the 1956 crisis, but attributed this crisis to speculation alone

³¹⁶ Flood and Marion, ‘Perspectives’

³¹⁷ See Krugman, ‘A model’, for a fixed exchange rate example

³¹⁸ Newton, ‘The two sterling crises’; Oliver, ‘The two sterling crises: comment’; Newton, ‘The two sterling crises: reply’

³¹⁹ Newton, ‘The sterling devaluation’, pp914, 925, 938, 940; Oliver, ‘The management’, pp601-2

ideas about confidence-driven switching, seen in the Triffin dilemma and the currency crisis literature, have dominated the thinking about crises in the post-war sterling area.

Another related question is persistence, why RSA countries did not switch earlier from sterling into other reserve assets. Here there have been several arguments made. We may categorise them into collective interest, loyalty, self-interest and political negotiation.

Firstly, Schenk argued that RSA countries were motivated by collective interest, characterising this as a form of network externality, 'being part of the benefits of sticking with an established collective system'.³²⁰ There was

'a rational understanding that diversification would disrupt the entire sterling system of exchange rate stability and damage the British economy (and perhaps the global monetary system) in ways that were not in the interests of its trading partners'.³²¹

Secondly, Eichengreen, while agreeing that RSA countries had such a collective interest, broadly rejected the role of network externalities in the persistence of sterling's role in the sterling area, and argued that countries were primarily acting under loyalty and colonial subservience.³²²

Thirdly, where members of the sterling area held particularly large stakes in the sterling system, collective interest could be argued to spill over into undiluted individual self-interest. This is the 'currency trap' argument, which has been applied to China's

³²⁰ Schenk, *The decline*, p89

³²¹ Schenk, *The decline*, p89

³²² Eichengreen, *Global imbalances*, p134

holdings of the dollar in recent years,³²³ and which, as earlier noted, Accominotti found in France's sterling in 1931.³²⁴ In the case of Malaysia and Australia in the 1960s, it was argued that these countries were constrained from diversifying from sterling by the sheer scale of their sterling holdings.³²⁵

Fourthly, Strange, following Shonfield's notion of a 'hard bargain' between the UK and ISA, introduced political definitions of top, master and negotiated currencies.³²⁶ A top currency is one which is dominant internationally purely for economic reasons. A master currency is one which is effectively imposed by an issuing state on follower states (e.g. colonies). A negotiated currency is one in which the issuing state, explicitly or implicitly, offers inducements to follower states to hold the currency. Strange argued that sterling in the post-war era was no longer a top currency. It was a master currency for the British colonies and a negotiated currency for the ISA – in the case of the latter, the agreement to hold sterling thus came at an economic cost for Britain.

These arguments are not necessarily mutually exclusive. The interesting question about collective interest and self-interest, as practised by RSA countries, is whether and why self-disciplined concern about the effects of a country's action on the sterling exchange rate would be limited to diversification (in the sense of switching) and not also to conversion (in the sense of spending sterling). As seen, writers such as Grey, Kamarck, Scott and Zupnick had argued that too much spending of sterling reserves could have negative consequences for sterling, and Hirsch had listed conversion as a cause of sterling crises. Even in the early post-war period, there had been a view that it was not just dollar spending that mattered: the constraints placed on India were not merely dollar rations but additional restrictions on releasing sterling.³²⁷ So, if RSA

³²³ Eichengreen, *Exorbitant privilege*, pp153-60; Prasad, *The dollar trap*

³²⁴ Accominotti, 'The sterling trap'

³²⁵ Schenk, 'Malaysia', Singleton and Schenk, 'The shift'

³²⁶ Strange, *Sterling*

³²⁷ Fforde, *Bank of England*, pp251-6

countries were motivated by concern for sterling, why were they not concerned about spending sterling? By contrast, adherence to rules (switching being against the rules and spending sterling being within them) could explain why countries might be free with their spending but careful about their switching.

3.3.4 Sterling balances – official and private holdings

One aspect of the sterling balances has received limited discussion in the literature: the distinction between official and private holdings of sterling. In analysing sterling's post-war decline, Schenk addressed both the reserve role and commercial/trading role of sterling as an international currency.³²⁸ Within the UK government, by the mid-1960s, there was a suggestion to reduce sterling's reserve role through long-term funding of excess sterling balances in the official RSA category, while maintaining its commercial and trading role, which was supposed to be reflected in the private holdings of both the RSA and NSA.³²⁹ Schenk observed that private holdings within the RSA seemed 'more robust to confidence in sterling' and connected this to sterling's commercial use.³³⁰

Symons also briefly addressed the trends in the RSA and NSA official and private holdings of sterling (see Table 6). NSA official holdings declined sharply (these were wartime accumulations such as those of Egypt); NSA private holdings were volatile and sensitive to relative interest rates and confidence; RSA official holdings, which formed the largest category, saw varied changes in country composition; RSA private holdings enjoyed strong growth.³³¹

³²⁸ The distinction is a common thread in Schenk, *The decline*

³²⁹ Schenk, *The decline*, pp254-6, 277-9

³³⁰ Schenk, *The decline*, p212

³³¹ TNA:T267/29, 'Sterling balances', pp54-8

£m	1949	1959	1969
Gross country holdings:			
RSA – official	1757	2165	2039
RSA – private	419	687	1134
NSA – official	720	326	107
NSA – private	363	620	546

Table 6: UK gross sterling liabilities as at end of December, 1949, 1959 and 1969 (£m)

Source: Extracted from TNA:T267/29, 'Sterling balances', p100, Appendix 1, and p102, Appendix 2

Note: Official holdings are 'Official' in 1949 and 1959 and 'Central Monetary Institutions excluding Central Bank Assistance' in 1969. Private holdings are 'Other' in 1949, 1959 and 1969

Noting that RSA non-official sterling holdings trebled in 1945-67 and did not seem to reflect the fortunes of sterling, Symons explained them as follows:

'The reason why these holdings have proved less volatile seems to have been partly because they have been more subject to official influences (through exchange control); partly because some of the funds may have been in the hands of official bodies not classified as central monetary institutions; and partly because they include the balances of the overseas offices of London banks'.³³²

The nature and meaning of the RSA non-official holdings therefore requires more definition. Sterling held as part of domestic monetary systems through currency boards and banks were a significant element of the sterling area system. Schenk made studies of such arrangements. Contrary to the arguments of some contemporaries that currency boards were exploitative,³³³ Schenk observed that they provided needed exchange rate stability, and central banks that replaced them were often no more independent.³³⁴

To summarise the sterling area literature: the 1950s-60s saw great changes in the sterling area's relative privileges and cohesion, and there is some doubt in the

³³² TNA:T267/29, 'Sterling balances', p56

³³³ Strange, *Sterling*, p65

³³⁴ Schenk, 'Monetary institutions'

literature about whether rules such as pegging, controls or pooling were even being followed in the 1960s. Although its 1940s interactions revealed negotiating strength, in the 1950s-60s the UK's direct powers of enforcement seemed weak – there was limited use of exclusion, blocking was a last resort, and cancellation (default) was not countenanced. Pegging to sterling or maintaining exchange controls were not particularly onerous requirements for the RSA under Bretton Woods, and the pooled gains (or losses) from the sterling area were not evenly distributed. There were arguments about whether the RSA countries were in deficit or in surplus, and what role they played in the sterling area balance of payments and sterling crises. There were disputes about the variability and liquidity of the sterling balances and the effect on reserves. Political relations with the UK were varied and complex, from highly independent nations (e.g. South Africa) to dependent colonies; RSA countries looked for different things out of the sterling area. It was suggested that the ISA was relatively quick to diversify away from sterling in the 1950s. There was uncertainty about the nature of the non-official sterling holdings within the RSA.

Section 4: The three papers and their research questions

The sterling area was a financial alliance of countries, with a core-periphery structure. In a world which is now becoming multipolar, with several large core units of population or geography (e.g. the USA, EU, China, India, Russia), and commitment to free trade seemingly on the wane, it is interesting to understand if financial alliances matter, and how they can make a difference to currencies and international reserves. In general terms, this makes the sterling area an interesting field for historical study.

The primary motivation of this thesis is to build on the work of earlier writers about the sterling area as it existed in the 1950s-60s, which means to fill 'study gaps' in what is a broad subject with many varied contributions. The topics chosen, Australia, Ireland and sterling crises, present themselves naturally as study gaps. Among the top five RSA countries in the 1960s in terms of sterling holdings, Australia and Ireland were the largest which have not received detailed study across the 1950s-60s. Schenk has already made close studies of Hong Kong and Malaysia (and, with Singleton, Australia from 1965), while access to archival material poses a problem for Kuwait. There have been no detailed historical studies which have examined the role of the broad sterling area in the sterling crises of the 1950s-60s up to the devaluation of 1967, a key event which led to the transformation of the sterling area away from a voluntary system, under the 1968 MSP agreements.

A secondary overarching motivation is to examine the institutional effects of the sterling area – in this case, on Australia, on Ireland and, via sterling crises, on the UK's international reserves. This period is interesting because the wartime and immediate post-war emergency was over, sterling's overvaluation had been corrected through the 1949 devaluation, convertibility was returning, growth and development priorities were at the fore, the sterling area's discriminatory cohesion seemed to be dissipating, and it

is unclear from the literature whether RSA countries were following, or disregarding, the supposed rules of sterling area membership. In these years, the sterling area was a voluntary system in which countries such as Australia and Ireland were in control of their destinies, even if policy was influenced by the environment in which they operated.

The hunch behind this thesis is that, despite its apparent vagueness, the sterling area mattered as an institution. However this does not seem currently to be the conclusion of the literatures regarding Australia, Ireland and sterling crises. To summarise, in advance, the leading conclusions of these literatures in the crudest possible terms: Australia's reserve management was that of a free portfolio manager, influenced primarily by economic – transactions and risk-return – considerations. Ireland's central bank was a virtual currency board from 1927 to 1979, with a fixed link to sterling. The sterling area played little role in sterling crises in 1950-67.

This is the point at which, in a paper-based thesis, the secondary overarching motivation drops away, and the topics themselves take over, and present their obvious priorities and research questions to the reader. In the case of Australia, the study is of central bank reserve management in the 1950s-60s in relation to sterling. The importance of sterling in Australia's reserves was in gradual decline over this period, and it would be beneficial to understand when, why and how that happened, and how reserve management was operating in practice. Australia was also an important sterling area member. That membership is largely taken as a given – the net benefits Australia received, whether through pooling, capital flow or other factors, were the dominant policy consensus of that time.

There is a tension in central bank reserve management between economic drivers – transaction needs and risk-return decisions – and the effects of sterling area

membership. This author does not seek to dispute the self-evident importance of the economic drivers. But, as a minimum, it would be good to know if Australia was following sterling area rules, i.e. acting under self-imposed constraints. If it was following rules when it had the power and opportunity to break them, it is probably too ambitious to untangle why it was doing so – the political or economic reasons. But the question whether it was doing so is of interest in itself. In some respects, sterling area rules and the economic drivers were perfectly aligned and it is impossible to distinguish between them. For instance, the sterling peg was both a sterling area rule and, as an economic driver, had significant reserve management effects. However, there was a potential conflict between the sterling area's pooling rule and transactions and risk-return factors. As we saw in the discussion of economic theory, the transactions motive seeks to minimise unnecessary FX transactions, while the pooling rule insists on FX transactions being made. Similarly, the risk-return motive encourages deliberate diversification, while the pooling rule refuses it. The study is not just about the pooling rule, however. It is also about the broader impacts of sterling area membership – sometimes operating indirectly via the economic drivers – and the organisational inheritance, and the balance-of-payments environment and the timing of decisions: the combined effect on Australian reserve management. Because it is considering change over time, the paper requires answers to two questions: Firstly, what influence did Australia's sterling area membership have on its reserve management? Secondly, when, why and how did Australia diversify its reserves in 1950-68?

The case of Australia is that of a supposed free agent, and the extent to which it was acting under self-imposed constraints. The Irish reserve management case is almost the reverse: a country acting under the constraints of the 'sterling link', where the transactional reasons for holding sterling seemed overwhelming. Nevertheless, during 1968-74, a dramatic diversification in reserves, away from sterling, took place, even while the 'sterling link' and those transactional drivers remained intact. This was

principally a portfolio management risk-return decision, and the 1967 devaluation was the catalyst for it, but it is too simplistic to express the change only in those terms: currency boards do not normally make such a switch away from the base currency to which they are pegged. Rather, one needs to look at the domestic financial system and the changes that occurred after the devaluation of 1967, particularly the 1968-9 centralisation of the commercial banks' holdings of sterling into the central bank, which enabled such a large switch to be made. In order to understand this move, it is necessary to understand why it had been prevented earlier. So in the case of Ireland there are two 'events' being studied, reserve diversification and the centralisation of reserves within the central bank. And there are two questions that need to be answered. Firstly, why did centralisation and diversification not take place before 1967? Secondly, how and why were centralisation and diversification achieved after 1967? Ireland's story here is really about the coming of age of its central bank. Ireland's sterling link and currency board arrangements were part and parcel of its membership of the sterling area. The negotiations and events which led to Ireland's centralisation and diversification were sterling area negotiations and events. The institutional effects in Ireland's case were complex inertial forces to be overcome by its reserve portfolio managers.

The third paper concerns sterling crises in 1950-67. The motivation of the paper is to engage with the fierce contemporary debate between defenders and critics of the sterling area system. The critics were, among other things, arguing that RSA balance-of-payments deficits were contributing to sterling crises – an institutional effect of the sterling area system on the UK's international reserves – and it would be useful to discover if they had good grounds for making this claim. One of the battlefields of the contemporary debate was the UK's balance of payments, which by accounting definition included changes in the sterling area's 'sterling balances' – changes in the UK's net external liabilities to the sterling area. The protagonists in this debate were

looking at the balance of payments in different ways – the critics of the sterling area system were looking at the ‘overall’ balance of payments of the RSA (largely in deficit even after including long-term capital flows); the defenders were considering the RSA’s balance of payments with the NSA (largely in surplus after including long-term capital flows). The contemporary economist, Richard Kahn, employed the former approach in two important government reports, using, inter alia, the monthly sterling balances of the RSA and NSA, assistance to the UK from the NSA, and published reserves, to investigate the sterling crises of 1964-8. The second, defender, viewpoint is unfortunately not susceptible to such treatment, since changes in the sterling balances of a sterling area country largely reflect its *overall* balance of payments. Because this monthly data, for the sterling balances, NSA assistance, and published reserves, is recoverable for all the crises in 1950-67, it is possible to simulate Kahn’s methodology in order to make an investigation – in contemporary terms – of the sterling area’s role in all these crises. The questions being asked in this third paper are as follows. Firstly, according to Kahn’s methodology, what part did the sterling area’s sterling balances play in the crises of the years 1950-67? Secondly, how should we critique and evaluate this methodology, and what conclusions can we draw about the sterling area’s role in these sterling crises?

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Chapter 2. Institutional effects: the case of Australia's diversification from sterling, 1950-68³³⁵

Section 1: Introduction

A source of concern in modern macroeconomic policy is the future of the US dollar as a world reserve asset.³³⁶ An historical precedent of this phenomenon is the evolution of sterling's international use after the Second World War.³³⁷ Despite a number of crises of confidence for the pound in the 1950s-60s, sterling area³³⁸ countries continued to hold sterling and, hence, its demise as a world reserve asset was delayed. However, there have been few in-depth studies of the reserve management of independent sterling area countries. If lessons about today's reserve currencies are to be drawn from sterling's past,³³⁹ we need to understand better the principal users of sterling in this period.

The constraints that affected the holding of sterling have been debated. Eichengreen suggested that loyalty to the UK and a desire not to damage an important economic partner deterred independent sterling area countries from diversifying (that is, replacing sterling with US dollars and other reserves).³⁴⁰ Strange said that the continued holding of sterling by these countries was a negotiated outcome, requiring British concessions.³⁴¹ And Schenk argued that holders of sterling refrained from

³³⁵ I am grateful for the assistance of staff at the Reserve Bank of Australia Archives, the National Archives of Australia, the Bank of England Archive and The National Archives of the UK. Selwyn Cornish and his assistant Greg Tyler, Official Historians at the Reserve Bank of Australia, provided helpful feedback on an earlier draft, as highlighted in the notes. So too did Lars Boerner and Albrecht Ritschl. During drafting, Olivier Accominotti, Peter Howlett and Joan Rosés provided helpful feedback. All errors are my own. The currencies in this article were valued as follows: £1 = A£1.25 (pre-1966) = A\$2.50 (1966-7) = A\$2.14 (1967-8). Unless context dictates otherwise, amounts have been converted into A\$ equivalent

³³⁶ Eichengreen, *Exorbitant privilege*; Chinn, 'Emerging market economies'; Lim, 'The euro's challenge'; Prasad, *The dollar trap*

³³⁷ Eichengreen, *Global imbalances*, pp123-48; Helleiner, *The status quo*; Schenk, *The decline*, pp414-6

³³⁸ As explained herein and in Schenk, *Britain*, the 'sterling area' was a group of countries, defined by UK exchange controls, which agreed informally to employ sterling as their principal international reserves, and to maintain exchange controls aligned with those of the UK

³³⁹ Eichengreen, *Global imbalances*, pp134-6; Schenk, 'The retirement'. Both caution against applying sterling's past inertia to predictions about the dollar

³⁴⁰ Eichengreen, *Global imbalances*, pp134-5

³⁴¹ Strange, *Sterling*, p300

diversification because of the costs of switching, a form of 'network externality'.³⁴² The aim of this study is to offer a more complete explanation for the resilience of the sterling area, which focuses on what it meant to be a member of the sterling area, and why sterling area countries held so much sterling while others did not. Countries were also tied to the sterling area by the institutional arrangements created precisely to establish this reserve currency system.³⁴³

This paper seeks to fill the research gap by examining the sterling reserve management policy of Australia from 1950 to 1968. In these years, Australia appeared to be a comparatively free agent with regard to sterling: the currency was not subject to the emergency sterling area co-operation of 1947-9,³⁴⁴ nor the formal agreements of 1968-74.³⁴⁵ Australia is particularly interesting because it was the largest holder of sterling for much of the period,³⁴⁶ and arguably the most important external member of the sterling area. Loyalty and independence were themes of the relationship. Australians had fought in Britain's wars. It had close political contacts and kinship relations with the UK.³⁴⁷ Yet it was also forging an independent path in the post-war world.³⁴⁸

Australia's holding of sterling appeared to be constrained in some way. According to the literature, it was an early diversifier and deliberately diversifying for a long time, throughout the 1950s-60s.³⁴⁹ Yet overall the diversification seemed moderate compared with some peers – at least in terms of sterling's share of reserves:³⁵⁰

³⁴² Schenk, *The decline*, pp88-9

³⁴³ The argument being made is analogous to/based on an earlier finding of Schenk, who showed that colonial holdings of sterling in the 1950s were illiquid due to sterling area institutional arrangements (Schenk, *Britain*, pp22-5)

³⁴⁴ Lee, *Search for security*

³⁴⁵ Singleton and Schenk, 'The shift'

³⁴⁶ Schenk, *Britain*, pp50-1; Schenk, *The decline*, pp89-90, 122

³⁴⁷ Ward, *Australia*

³⁴⁸ Lee, *Search for security*

³⁴⁹ Schenk, *Britain*, pp31-2; Schenk, *The decline*, pp89, 296, 300-1

³⁵⁰ See Annex 2 for the peer comparison. India's sterling share changed more. However, there is a methodological problem with sterling's share as an indicator of deliberate diversification (see herein), so it would be wrong to draw too many conclusions from Annex 2

between 1950 and the 1967 devaluation of sterling, sterling's percentage share of its gold and currency reserves declined from the low 90s to the low 60s.³⁵¹ But what did this change in sterling's share mean? Was it a little, or a lot? The puzzle to be explored is why Australia held onto sterling, even after its trade and debt orientation seemed to have shifted away from the UK. This leads to the question, *When, why and how did Australia diversify its reserves in the years 1950-68?* In order to answer this, we need the solution to another question, *What influence did Australia's sterling area membership have on its reserve management?*

Little has been written about the influence of the sterling area on Australia's reserve management. Schenk cited the Australian Prime Minister, in the mid-1950s, saying that Australia needed to hold at least £200m sterling in its reserves, which suggests an institutional sterling area effect.³⁵² As for diversification, the literature has indicated that Australia was engaging in this throughout the period.³⁵³ In the 1950s, the move away from sterling was interspersed with occasional episodes of support for the currency.³⁵⁴ In the 1960s, diversification was more deliberate, in response to the changing forces of trade and capital source and the greater weakness of sterling.³⁵⁵ There has only been one thorough study of Australia's reserve management, and this covered a later period, 1965-76.³⁵⁶ In that paper, Singleton and Schenk argued that, in the pre-1968 period as well as later, the warranted movement away from sterling based on Australia's changing trade and debt sources was constrained by three factors: the drawbacks of alternative assets, continued desire to access the London capital market, and collective interest in avoiding a collapse of the pound. Indeed, on the last of these points, Schenk argued that not just Australia but also Malaysia, two of the largest

³⁵¹ See Figure 5

³⁵² Schenk, *Britain*, pp25-6

³⁵³ Schenk, *The decline*, p89, for the 1950s

³⁵⁴ Robertson, 'The decline?', p113; Schenk, *Britain*, pp25, 32

³⁵⁵ Singleton and Schenk, 'The shift'

³⁵⁶ Singleton and Schenk, 'The shift'. They also covered New Zealand, which was a smaller player in the RSA, more dependent on the UK, and less promising as a case study for the issues under investigation

holders of sterling in the mid-1960s, may have been constrained from selling by the sheer size of their holdings,³⁵⁷ a classic 'currency trap'.³⁵⁸

The evidence about Australia's reserve management lies primarily³⁵⁹ in the Australian central bank and government archives, particularly those of the Reserve Bank of Australia (RBA) in Sydney.³⁶⁰ Economic historians have looked carefully at RBA material, but the RBA's records are extensive, and by examining more than a hundred files covering a broad period of nearly 20 years, this study has uncovered telling new evidence. The types of files viewed include board minutes, committee files,³⁶¹ departmental files, files covering communication with the London office, and personal and correspondence files for key RBA personnel. The most valuable evidence has been found in the internal contacts between the RBA's Sydney and London offices, which reveal officials' thinking about reserve management.³⁶²

Based on the new archival research, this paper concludes that sterling area membership – its rules and institutional inheritance – had a profound effect on Australia's reserve management, especially in determining *how* Australia diversified. Australian officials followed the reserve-pooling rule of the sterling area closely, because they valued membership of the area and were in turn influenced by it. In the context of sterling area rules, there was no deliberate diversification until 1962,³⁶³ and over the whole period Australia diversified by little more than its gold production. The

³⁵⁷ Singleton and Schenk, 'The shift'; Schenk, 'Malaysia'

³⁵⁸ For recent discussion about the 'dollar trap' (e.g. China's), see Eichengreen, *Exorbitant privilege*, pp153-60, Prasad, *The dollar trap*. See also Accominotti, 'The sterling trap'

³⁵⁹ The National Archives of the UK (TNA) and Bank of England Archive (BOE) have provided supporting evidence

³⁶⁰ The Australian central bank was the Commonwealth Bank of Australia (CBA), which combined central bank and commercial bank operations, until 1960, when it was renamed the Reserve Bank of Australia (RBA), a pure central bank, under new legislation. In this study, 'central bank' and 'RBA' are most commonly used to describe the central bank, although occasionally 'CBA' is used, where relevant to the context

³⁶¹ Such as the Commonwealth Bank Advisory Committee (CBAC) and Investment Committee

³⁶² A similar approach has been taken at the National Archives of Australia (NAA) in Canberra: for example, internal communications between Australian Treasury staff in Canberra and their colleagues in London and Washington

³⁶³ Except for the retention of newly-mined gold from 1951

findings are consistent with the institutional parts of Singleton and Schenk's explanation i.e. the 'London capital market' and some of the 'collective interest', but not the 'alternative assets' constraints. The findings are also largely supportive of Schenk's 'costs of switching' argument, but through a different mechanism than the 'sterling trap', one which emphasises the value of sterling area membership to Australia. Transactional and risk-return motives mattered in Australia's reserve management, but rules mattered too, and, as we will see, rules could have path-dependent effects.

The plan of the paper is as follows. Section 2 sets out the historical context, literature, data and sources. Section 3 reviews the RBA's reserve data, revealing Australia's true path of deliberate diversification from sterling. Section 4 analyses reserve management at a detailed level, in order to untangle transactional, risk-return and reserve-pooling drivers. Section 5 considers the macroeconomic policy benefits of sterling area membership, and identifies seven broad effects of sterling area membership on Australia, together with associated evidence. Section 6 traces changes in diversification policy and evaluates the constraint of sterling area membership against the constraints on diversification found in Singleton and Schenk's paper. Section 7 concludes with a discussion about the implications of Australia's case for the sterling area and reserve currencies today.

Section 2: Historical context, literature, data and sources

Overall, the 1950s-60s were 'extraordinary years' for Australia, 'marked by full employment, low inflation and sustained economic growth'.³⁶⁴ There was continuity in government, the Australian Treasury and central bank.³⁶⁵ Policy reflected a strong development agenda, characterised by high levels of immigration,³⁶⁶ imports of capital and capital goods, government borrowing overseas, current account deficits and protection for Australian manufacturing industry.³⁶⁷ Due to its export reliance on commodities, particularly wool,³⁶⁸ together with increasing imports and some domestic macroeconomic policy problems (see below), Australia's balance of payments was volatile, and there were several major downturns in international reserves (1951-2, 1954-6, 1960-1, 1964-8).³⁶⁹ In 1952-60, the volatility was partially managed through general import controls, including against sterling area goods.³⁷⁰ In the 1960s the focus turned more to tariffs and fiscal/monetary policy, with non-discrimination and convertibility for Australia's currency.³⁷¹

Australia faced some macroeconomic problems, particularly in 1950-61, as policymakers struggled to manage credit growth and inflation (see Figure 1 which compares Australia's CPI inflation with that of the UK, and relative yield differentials).³⁷² Australia's experience in the Great Depression had been traumatic,³⁷³

³⁶⁴ Cornish, *Sir Roland Wilson*, p30; Singleton and Robertson, *Economic relations*, pp18-25; Whitwell, 'Economic policy', pp166-84

³⁶⁵ The Liberal-Country party coalition governed throughout these decades, led initially by Prime Minister Menzies (1949-66); there was also a dominant Treasury Secretary, Wilson (1951-66); and central bank Governor Coombs (1949-68)

³⁶⁶ Australia's census population increased from around 8 million (1947) to 12 million (1966) (Boehm, *Twentieth century*, p51)

³⁶⁷ Menzies' government was 'intoxicated by the spirit of developmentalism' (Whitwell, 'Economic policy', p169). See Firth, *Australia*, p15; Lee, *Search for security*, pp143-60

³⁶⁸ Crawford, *Australian trade policy*, pp410-1 (from Commonwealth Statistician, *Oversea Trade*)

³⁶⁹ Cornish, *The evolution*, pp52-8. The reserve downturns were also attributable to a continuous policy of cheap money (Coombs, *Trial balance*, pp152-161; Cornish, *The evolution*, pp37-8), ineffective macroeconomic policy (Schedvin, *In reserve*, pp89) and a subservient central bank, with belated responses to excesses leading to a 'stop-go' effect (Schedvin, *In reserve*, pp116, 246, 296-7, 331, 352; Singleton, *Central banking*, p28). In 1952 and 1961, they prompted Australia to draw from the IMF

³⁷⁰ Crawford, *Australian trade policy*, pp490-525; Whitwell, *The Treasury line*, p132

³⁷¹ Australia achieved IMF Article VIII status in Jul/1965 (de Vries, 'A convertible currency', p292)

³⁷² Particularly Beggs, *Inflation*

consequently there was general antipathy towards 'deflationist' policies,³⁷⁴ and the authorities' relevant priorities were, firstly, full employment³⁷⁵ and, secondly, low interest rates³⁷⁶ – even minor divergence from these policies was likely to be punished at the ballot box (which happened in 1961).³⁷⁷ Indeed, at the Bretton Woods negotiations in 1944, the Australian government had pushed strongly for a 'positive approach', requiring priority commitment to full employment among all member countries, and, not being satisfied (with this or the size of its own quota), declined to join at the outset.³⁷⁸ There was a unique system of centralised wage arbitration, with elements of inflation-linking, one of whose concerns was to protect labour's share of income.³⁷⁹ Fiscal policy, although directed towards balanced budgets, and countercyclical to a degree, did not always compensate in a timely fashion for deficiencies in monetary control.³⁸⁰ The simultaneous attainment of full employment, price stability and external viability was arguably not feasible, as Beggs explained, citing the 1965 Vernon Report.³⁸¹ The central bank initially struggled to control the financial sector.³⁸² In this setting, fixed exchange rates were valued not only as a source of stability for trade and capital flow, but also as a disciplinary target for the control of inflation.³⁸³ However, this was not 'gold standard' thinking: devaluation (from £1 = A£1 to £1 = A£1.25) had been part of the solution in 1931,³⁸⁴ and farmers/exporters favoured a competitive exchange rate.³⁸⁵ The eight years of import

³⁷³ Cornish and Schuler, 'Australia's full employment', p2

³⁷⁴ See Treasury Secretary Wilson's comment on Melville in Cornish, 'Leslie Galfreid Melville', p475

³⁷⁵ Beggs, *Inflation*, p3

³⁷⁶ Beggs, 'The evolution', pp26-7; Corden, 'Australian economic policy', pp112-3

³⁷⁷ Corden, 'Australian economic policy', p115

³⁷⁸ Cornish and Schuler, 'Australia's full employment'; Markwell, 'Keynes and Australia'. It joined in 1947

³⁷⁹ Corden, 'Australian economic policy', pp89-98

³⁸⁰ See Melville's comments on Wilson, who dominated economic policy (Cornish, 'Sir Leslie Melville', pp452-3); Beggs, *Inflation*, pp73-86; Coombs, *Trial balance*, pp160-1; McLean, *Why Australia prospered*, pp191-3

³⁸¹ Beggs, *Inflation*, p17. The Vernon Report, reviewing Australia's economy, followed the credit squeeze of 1960-1 and criticised stop-go macroeconomic policies and encouraged longer-term planning (Coombs, 'Sir Leslie Melville', p453; Dyster and Meredith, *Australia in the international*, pp238-44)

³⁸² Beggs, 'The evolution'; Coombs, *Trial balance*, pp147-61; Corden, 'Australian economic policy', pp109-15

³⁸³ The CBA pushed unsuccessfully for an appreciation against sterling in 1950 for this reason (Coombs, *Trial balance*, p150). See Beggs, *Inflation*; Beggs, 'The evolution'; Cornish, 'Sir Leslie Melville'

³⁸⁴ Cornish, 'Sir Leslie Melville', p445

³⁸⁵ Coombs, *Trial balance*, p150

controls contributed to a prevailing 'balance-of-payments pessimism'.³⁸⁶ Domestic production, exports and capital inflows³⁸⁷ were encouraged in order to feed, house and employ a growing population, and a stable *competitive* rate supported these goals: the policy preference was 'fixed but flexible'.³⁸⁸ After the Labour government's initial reluctance, Australian administrations in the 1950s became committed to the international financial system and found the World Bank and the IMF useful sources of capital, crisis support, and superstructure for stable exchange rates and convertible currencies.³⁸⁹

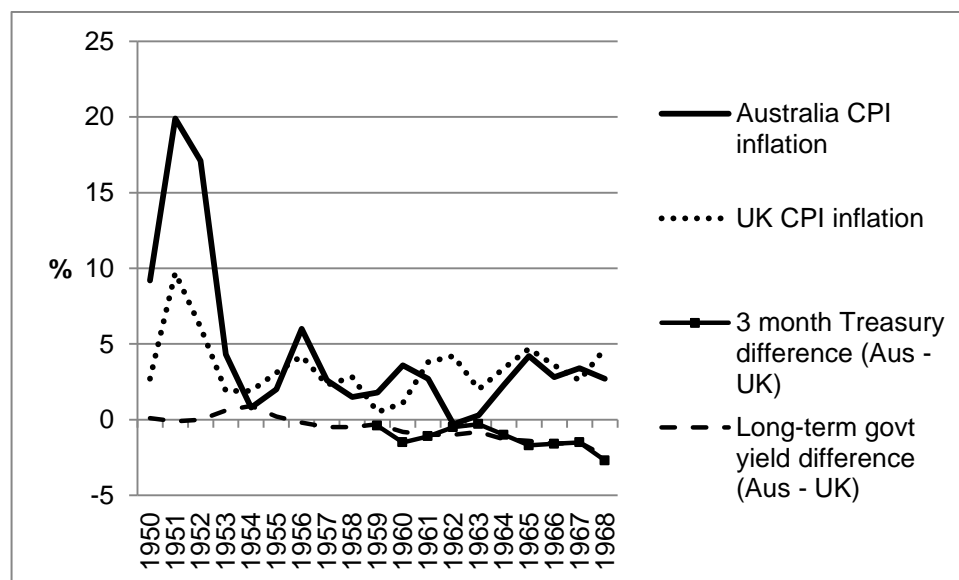


Figure 1: Australia and UK inflation and government yield differentials, 1950 – 1968 (%)

Source: Taken or calculated from Norton and Kennedy, *Australian economic statistics*, pp194-5, 214-5. The authors cite a number of sources

Note: Inflation = percentage change in annual averages for Consumer Price Index; government yield differentials = annual averages

Under these circumstances (fixed exchange rates, full employment, low interest rates, problems in credit control and inflation, a small economy with a fast-growing

³⁸⁶ Corden, 'Australian economic policy', pp101-3

³⁸⁷ Alongside the competitiveness concern, there was a countervailing worry that devaluation might endanger capital inflow (Corden, 'Australian economic policy', p100)

³⁸⁸ Cornish, 'Leslie Galfreid Melville', pp475-6

³⁸⁹ Dyster and Meredith, *Australia in the international*, p185

population, and commodity trade), the balance of payments became a major constraint:

‘the short run was always bounded by a necessity to keep foreign currency from running out, and the long run involved projects of reshaping economic relations to lessen the cyclical tendency towards payments deficits’³⁹⁰

A solution lay in monetary control. After the war, the central bank, having been in conflict with government in the 1930s,³⁹¹ was now more under the government’s thumb as a result of new 1945 legislation.³⁹² In the 1950s, it had a hard job convincing the Treasury to allow interest rates to rise.³⁹³ The financial system, divided largely into more active ‘trading banks’ and more passive domestic ‘savings banks’, was highly liquid, and a struggle ensued as the central bank tried to control the trading banks, while the latter resisted. This resistance was partly driven by the fact that the CBA also operated its own competitor trading and savings bank – it was only shorn of its private activities when it became the RBA in 1960. In 1947, there had even been an attempt, thwarted by the courts, by the then Labour government to nationalise the trading banks, after they had rejected transfer of public authority accounts to the CBA.³⁹⁴ In the 1950s, the central bank, gradually persuading the Treasury, stepped back from the management of low government bond yields, and increased the permitted levels for commercial interest rates: by the mid-late 1950s, interest rates were more responsive to the CBA’s wishes (see Figure 2). It tried to use the principal monetary policy tool, compulsory deposits through special accounts, but this was a blunt instrument with uneven effects, and had to be amended with a more conventional and universally applied liquidity ratio.³⁹⁵

³⁹⁰ Beggs, *Inflation*, p68

³⁹¹ Cornish, ‘Sir Leslie Melville’

³⁹² Schedvin, *In reserve*, pp62-71

³⁹³ Coombs, *Trial balance*, pp150-3

³⁹⁴ May, *The battle*; Beggs, *Inflation*; Corden, ‘Australian economic policy’, pp110-2

³⁹⁵ Beggs, ‘The evolution’

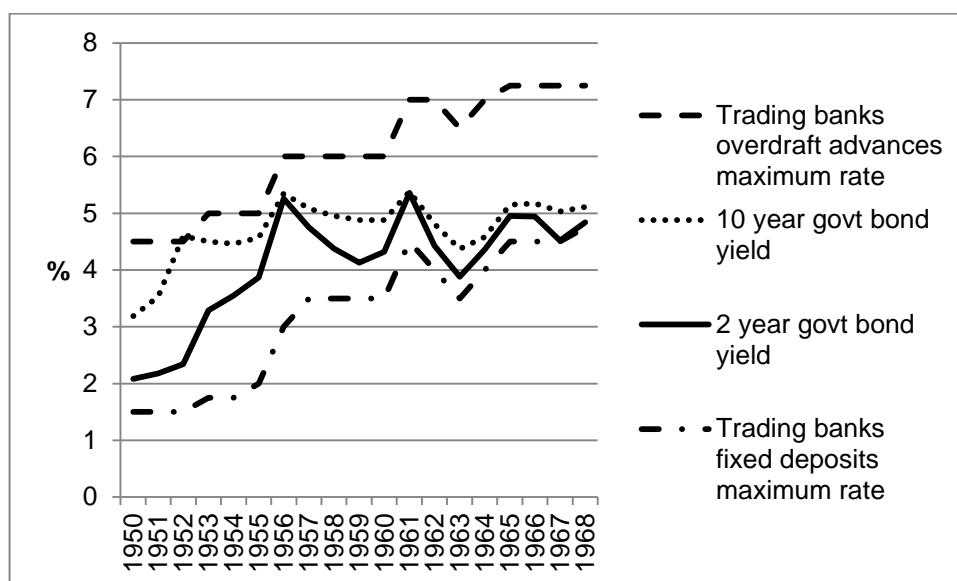


Figure 2: Selected Australian interest rates, government bond yields and trading banks' maximum fixed deposit and overdraft advances rates, at end of June, 1950 – 1968 (%)

Source: Norton and Kennedy, *Australian economic statistics*, pp84, 87

The three major crises of 1951-2, 1955-6 and 1960-1 illustrate how the domestic monetary situation fed through to deficits. The 1951-2 crisis – the most serious – was caused primarily by the Korean war wool boom, which increased export incomes and led to inflationary spending in the economy, followed by an equally savage bust.³⁹⁶ The 1955-6 crisis was driven primarily by excess credit creation in the trading banks. While the changes in bank liquidity control addressed this, the 1960-1 crisis derived from excess credit creation in unregulated non-bank financial institutions, brought to an end by a deliberate credit squeeze. The 1960s saw greater use of relative interest rate signalling, and monetary policy was more successful, and the downturn in reserves to 1968 was primarily caused by a drought and a mining boom as Australia sought to exploit its vast mineral resources.³⁹⁷

³⁹⁶ Copland, *Inflation and expansion*, explored policy issues in 1950-1, including the need to address inflation arising from Australia's growth trajectory and to restructure the economy

³⁹⁷ Beggs, *Inflation*; Beggs, 'The evolution'; Coombs, *Trial balance*, pp136-61. Dyster and Meredith, *Australia in the international*, pp244-8 for the mining boom

As a sterling area country, Australia followed informal rules: pooling reserves with the UK, operating exchange controls aligned with the UK, and pegging its currency to the pound.³⁹⁸ (For a summary of the rules, see Annex 1). Australia pegged its currency to sterling for 40 years (1931-71). There was a change in name (from the Australian pound to the Australian dollar, converted at A£1 = A\$2) in 1966, and a change in rate in 1967, when Australia decided not to follow sterling's devaluation (it had followed sterling in the 1949 devaluation).³⁹⁹ Australia's external orientation altered significantly over the 1950-68 period, in terms of trade, debt and FDI. By the early 1960s only around a quarter of Australia's trade was with the UK at a time when sterling was more than 90 per cent of its reserves.⁴⁰⁰ Trade with the USA and Japan increased particularly, and both overtook the UK as a trading partner by the mid-late 1960s.⁴⁰¹ The USA was contributing more FDI than the UK by the early 1960s.⁴⁰² Around half of external government debt was sterling-denominated by the end of the period, but the declining share indicates a lower proportion of new issuance.⁴⁰³ Membership of the sterling area was regarded largely as a given during this period. The economist Perkins attempted a qualitative cost-benefit appraisal in 1962. He argued for a balance of historical benefits both for Australia and the UK; was inconclusive about the future while positive about the possibilities of mutual co-operation; and suggested that quantitative analysis was impossible due to the lack of an imaginable counterfactual.⁴⁰⁴

³⁹⁸ From RBA archival material, the statement that Australia was following a reserve-pooling rule is strongly supported: see evidence in Section 4

³⁹⁹ Schedvin, *In reserve*, pp550-2

⁴⁰⁰ Singleton and Schenk, 'The shift', pp8-9. They called the trade with the UK 'trade denominated in sterling' (idem, p8), but sterling trade was much wider. As this paper discusses, sterling represented around 70% of Australia's total external payments in the early 1960s, nearly three times the UK trade share

⁴⁰¹ USA as a source of imports, and Japan as a destination for exports, see Dyster and Meredith, *Australia in the global*, Table 8.4, p192

⁴⁰² Figure 15

⁴⁰³ Singleton and Schenk, 'The shift', p9; Schenk, *The decline*, p300.

⁴⁰⁴ Perkins, *Britain and Australia*, especially pp140-97. Perkins was sure that Australia was then carrying out the 'long-accepted obligations as a member of the sterling area', including reserve pooling, although he thought those obligations might merit some reconsideration (p195)

Despite the Treasury's power and influence,⁴⁰⁵ the central bank was responsible for reserve management: it was the risk manager, and it employed a strict exchange control framework.⁴⁰⁶ All gold and foreign exchange in Australia, including sterling, was mobilised into the RBA's balance sheet. The trading banks held foreign currencies in the course of mobilisation, but only a small proportion of the total, acting as the RBA's agent.⁴⁰⁷ In 1947-51, as a temporary measure of support, Australia sold its gold production to the UK for sterling, but in 1951, the government ruled that henceforth all newly-mined gold (either the gold itself or its proceeds in US dollars from sales on the international 'gold premium' market) would be retained in the central bank.⁴⁰⁸

The literature has described Australia's diversification from sterling in terms of sterling's share of its gold and currency reserves, and tended to attribute a declining sterling share to deliberate diversification policy.⁴⁰⁹ In answer to the question, 'when did Australia diversify?', the literature has followed sterling's share and indicated that diversification was taking place in 1950-8 and 1964-68.⁴¹⁰ In the middle period, to mid-1964, sterling's share increased again to a high level, but the literature has not addressed the reason for this. Authors have also tried to pinpoint when Australian policy or sentiment turned away from the UK. For Lee it was 1949 (the Menzies government), for Singleton and Robertson the mid-1950s (a growing mutual disenchantment), for Ward 1961 (the UK's EEC application).⁴¹¹

⁴⁰⁵ Singleton, *Central banking*, pp28-9 described the RBA Governor as 'the compliant central banker'

⁴⁰⁶ Schenk, *Britain*, p32. Exchange controls were well-aligned with the sterling area

⁴⁰⁷ Schedvin, *In reserve*, pp17-8, 59, 69-70, 290. The exchange mobilisation rules lasted from 1939 to 1983

⁴⁰⁸ TNA:T267/29, 'Sterling balances', pp60-1

⁴⁰⁹ Schenk, *The decline*, p89

⁴¹⁰ Schenk calculated Australia's sterling share from BOE data in this period. Between Dec/1950 and Dec/1958, these figures showed Australia's sterling share of reserves declining from 82% to 55%. Between Dec/1964 and Oct/1967 there was a decline from 79% to 60%, followed by a decline by Dec/1968 to 46% (Schenk, *The decline*, pp89, 296). Singleton and Schenk also showed a chart of sterling's share of reserves between 1960 and 1980. The decline starts around 1964, from above 90% (Singleton and Schenk, 'The shift', pp8-9). The 1950s percentage figures above are significantly lower (by up to around 20 percentage points) than the percentages shown in Section 3, which are sourced from RBA data, or those in Annex 2, from BOE data. The main reason for the difference is technical, relating to the calculation of sterling's share, and need not detain the reader. The analysis of this paper is based largely on the official RBA data in Section 3

⁴¹¹ Lee, *Search for security*; Singleton and Robertson, *Economic relations*, p215; Ward, *Australia*

Why did Australia diversify? Authors cite trade orientation and debt source, following studies showing that these, with anchor currency, influence the composition of reserves.⁴¹² Singleton and Schenk attributed diversification to 'changing patterns of trade and debt and falling confidence in British economic policy'.⁴¹³ They emphasised debt source.⁴¹⁴ Schenk observed that the Australians started to accumulate dollars in the early 1950s in order 'to meet their maturing dollar obligations'.⁴¹⁵ However, Strange attributed Australia's diversification in the 1960s to political considerations, e.g. the UK's first EEC application.⁴¹⁶

Regarding constraints, some argued that diversification was limited by loyalty or support for the UK. Robertson wrote that the Menzies government was essentially pro-British, evidenced by secret gifts of gold and foreign exchange to the UK between 1956 and 1961.⁴¹⁷ Schenk also noted that Australia in the 1950s 'periodically responded to general sterling area requirements', e.g. making contributions of dollars and gold in 1952 and 1956.⁴¹⁸ Kirshner went so far as to describe Australia's sale of £20m of gold to the UK during the Suez crisis as a minor example of successful protective currency manipulation.⁴¹⁹ However, considering the 1960s, Singleton and Schenk rejected the loyalty argument, contending that Australia held sterling 'for economically rational reasons' and 'based on calculation rather than sentiment or coercion'.⁴²⁰ Instead, they proposed three specific constraints on diversification – collective interest in avoiding a collapse in sterling, a sanguine view of sterling's risk-return prospects relative to the dollar, and a continued desire to access the London capital market.

⁴¹² Dooley, Lizondo and Mathieson, 'Currency composition'; Eichengreen and Mathieson, 'Currency composition'

⁴¹³ Singleton and Schenk, 'The shift', p2

⁴¹⁴ Singleton and Schenk, 'The shift', pp5-12

⁴¹⁵ Schenk, *Britain*, p32

⁴¹⁶ Strange, *Sterling*, p91

⁴¹⁷ Robertson, 'The decline?', p113. Robertson was citing a letter from Australian Treasurer Holt to the UK Chancellor of the Exchequer in 1961

⁴¹⁸ Schenk, *Britain*, p32

⁴¹⁹ Kirshner, *Currency and coercion*, pp67,109

⁴²⁰ Singleton and Schenk, 'The shift', p13. See Schenk, *The decline*, p30 for a rejection of the loyalty argument

The first of these includes the ‘sterling trap’⁴²¹ argument: ‘the need to avert capital losses that might arise from rapid sales of sterling assets’.⁴²² There was also a network effect among other holders of sterling: news of any Australian plan to diversify risked ‘a stampede that would devalue remaining reserves’.⁴²³ Evidence for the latter view was found in the RBA Governor’s reassurance to the Bank of England in July 1967 and an internal RBA paper in November 1967.⁴²⁴ Australia had ‘too much to lose to take the risk of... prompting a collapse of the sterling exchange rate’.⁴²⁵

The second reason, the drawbacks of alternative assets, was a risk-return assessment. Sterling was not so unattractive to Australia because of ‘relatively high interest rates’ and the dollar’s ‘declining resilience’,⁴²⁶ ‘weakening during the Vietnam era’.⁴²⁷ Other countries such as West Germany and Japan were also reluctant for their currencies to be used as reserve assets.⁴²⁸ The authors presented the doubts about the dollar as a challenge to the literature where ‘the assumption is that the US dollar was all-conquering by the mid-1960s’.⁴²⁹ Their view thus contradicted the claim that sterling’s dollar peg was not ‘credible’, in the judgement of the market, in 1964-7.⁴³⁰ However, the earliest evidence presented for this caution about the dollar was from a RBA board meeting in July 1968.⁴³¹ Moreover, as they also observed, in July 1968, the RBA was seeking to reduce sterling and accumulate dollars, notwithstanding sterling’s high interest rates and the dollar’s problems.⁴³²

⁴²¹ Part of the currency trap analysis lies in establishing that the central bank concerned is ‘a large player in a low-credibility system’ (Accominotti, ‘The sterling trap’, pp366-7). Accominotti argued that France was a big sterling player because, even at end-1931, its sterling holdings represented half the UK’s international reserves (idem, p367). The same was roughly true of post-WW2 Australia (see Figure 18)

⁴²² Singleton and Schenk, ‘The shift’, p12

⁴²³ Singleton and Schenk, ‘The shift’, p13

⁴²⁴ Singleton and Schenk, ‘The shift’, p13

⁴²⁵ Singleton and Schenk, ‘The shift’, p13

⁴²⁶ Singleton and Schenk, ‘The shift’, p13

⁴²⁷ Singleton and Schenk, ‘The shift’, p21

⁴²⁸ Singleton and Schenk, ‘The shift’, p21

⁴²⁹ Singleton and Schenk, ‘The shift’, p21

⁴³⁰ Bordo, Macdonald and Oliver, ‘Sterling in crisis’

⁴³¹ Singleton and Schenk, ‘The shift’, p9

⁴³² Singleton and Schenk, ‘The shift’, p14

The third constraint was desire for continued access to the London capital market for government borrowing. In 1968, this was a 'key priority' for the Australian Treasury,⁴³³ which wrote access into the 1968 MSP agreement.⁴³⁴ For Singleton and Schenk, capital markets were 'driving factors' in Australia's distribution of reserves.⁴³⁵ Schenk noted that the RBA was keen to diversify further from sterling 'in the years prior to the devaluation of 1967', but was overruled by the government, whose policy was to keep the bulk of reserves in sterling.⁴³⁶ The continuing policy "to hold our main overseas reserves in sterling" was referenced in a letter from the Australian Treasurer to the British Chancellor in July 1967.⁴³⁷

There are two observations to make about these constraints. The first is that, while these arguments were about the 1960s as whole,⁴³⁸ the evidence presented was quite late, 1967-8. In fact the earliest cited evidence about the RBA's preferred distribution of reserves (equal shares between sterling, dollars and gold) was in July 1968.⁴³⁹ Singleton and Schenk also suggested that 'the pace of change' in reserve distribution policy 'accelerated sharply after the 1967 devaluation', due to exchange losses.⁴⁴⁰ This indicates a need to uncover earlier evidence about distribution intentions and so assess the pre-devaluation period. The second observation is that the first two constraints (avoiding a sterling collapse, and relative currency attractions) were about risk (relevant for the risk manager, the RBA), while the third was political, involving government borrowing (the domain of the Treasury). Given that the RBA wanted to diversify faster and was being overruled by the Treasury, this raises the question how strong the first two constraints were versus the third.

⁴³³ Singleton and Schenk, 'The shift', p14

⁴³⁴ Singleton and Schenk, 'The shift', p16

⁴³⁵ Singleton and Schenk, 'The shift', p11

⁴³⁶ Schenk, *The decline*, p300

⁴³⁷ Singleton and Schenk, 'The shift', p9

⁴³⁸ The citations are largely taken from the section about the 1960s up to the MSP agreements of Sep/1968 (Singleton and Schenk, 'The shift', pp8-13)

⁴³⁹ Singleton and Schenk, 'The shift', p14

⁴⁴⁰ Singleton and Schenk, 'The shift', p9

How did diversification take place? Authors acknowledged that it sometimes occurred through balance-of-payments deficits falling on the sterling holdings.⁴⁴¹ Strange pointed to deliberate accumulation of gold, dollars and IMF credits in the 1960s.⁴⁴² Singleton and Schenk did not refer to IMF credits, but argued that new foreign borrowings led directly to the retention of the borrowed currencies in the RBA's reserves.⁴⁴³ Explaining the decline in sterling's share to 64 per cent by mid-1967, they also noted 'a modest accumulation of dollars' arising from premium gold sales and a decision in 1965 to retain, in dollars, dollar earnings from US investments.⁴⁴⁴

The impact of sterling area membership on diversification has not received much focus from the literature. Schenk drew attention to Australia's need for minimum 'working balances'⁴⁴⁵ in the 1950s. Perkins guessed at a 'bare minimum' sterling reserve of £100-200m and target 'average' of £250-300m.⁴⁴⁶ Singleton and Schenk acknowledged that, due to the sterling peg, 'sterling was needed for intervention and precautionary purposes'⁴⁴⁷ in the 1960s. However, generally, there has been a presumption that the bonds of the sterling area were weakening and that, after 1960, the sterling area was an 'anachronism'.⁴⁴⁸ 'After the restoration of convertibility and the termination of dollar pooling in 1958, the Sterling Area was of little significance'.⁴⁴⁹

⁴⁴¹ Schenk, *Britain*, pp25-6; Schenk, *The decline*, p89; Singleton and Schenk, 'The shift', p9; Strange, *Sterling*, p90

⁴⁴² Strange, *Sterling*, p91

⁴⁴³ 'There was a direct relationship between foreign currency borrowing and the denomination of reserves when the proceeds of foreign loans were converted to domestic currency for local government spending' (Singleton and Schenk, 'The shift', p10); mid-1960s borrowings in Deutschmarks and Swiss francs 'increased foreign exchange reserves' (idem, p11); reserves 'were diversified through foreign borrowing' (idem, p12)

⁴⁴⁴ Singleton and Schenk, 'The shift', p8

⁴⁴⁵ Schenk, *Britain*, p26

⁴⁴⁶ Perkins, *Britain and Australia*, p146

⁴⁴⁷ Singleton and Schenk, 'The shift', p12

⁴⁴⁸ Robertson and Singleton, 'The Commonwealth', p265. They claimed that the Commonwealth economic community was 'increasingly irrelevant' to Australia in the 1960s (Singleton and Robertson, *Economic relations*, p3)

⁴⁴⁹ Robertson and Singleton, 'The Commonwealth', p260

The literature thus reveals conflicting arguments and many elements at work (e.g. balance-of-payments effects, minimum sterling needs, IMF credits, a newly-mined gold retention policy). But there is a need to understand how they all fitted together in terms of operational practice and strategic direction.

Finally, some comments on data and sources are merited. The RBA's files contain various reserves series on a roughly monthly basis, particularly those regularly presented to board meetings,⁴⁵⁰ but due to variations in date and composition they are not consistent over the 1950-68 period. Thus these are used to analyse episodes and fill gaps, but for an overview the annual (end-June) reserves data from the RBA's website has been used.⁴⁵¹ The reserves there are divided into four components: US dollars, 'Other', the reserve position at the IMF, and gold. Comparison with the board series soon reveals that 'Other' was entirely sterling, until, just before the November 1967 devaluation, a tiny amount of Deutschemarks was added. In June 1968 only A\$4m of Deutschemarks was held. An annual series misses the intra-year highs and lows in reserves. Sterling holdings reached their minimum levels in September 1952, June 1956, March 1961 and September 1968. The principal low missed by the annual June data was that in 1961, because Australia drew from the IMF in April 1961.

The RBA's annual accounts show that its assets were held in two funds, the Central Banking Business and the Note Issue Department (NID). The international reserves in the Central Banking Business increased and declined with the balance of payments. The assets held in the NID matched and grew with the note issue. The archives reveal that sterling held in the Central Banking Business was managed in the RBA's London office, with oversight from Sydney, and was called the 'London funds'. The assets of the NID were managed from Sydney, with this department's UK Treasury bill portfolio

⁴⁵⁰ The currency distribution of reserves was in a monthly Memorandum to the RBA board entitled 'Overseas Funds'. See RBA:BM-Pe- series

⁴⁵¹ Figure 3

being managed by the Bank of England.⁴⁵² Periodically, currencies were sold from one fund to the other in order to meet shortages. The precise annual sterling holdings of the NID could not be isolated, but various archival references indicate changes in policy and share. There is a good run of 'London funds' data in 1953-62 contained in monthly reports from the London office.⁴⁵³

The approach to the qualitative evidence (RBA and Treasury files) is to be sceptical about the diplomatic communication between Australia and the UK. There was an understandable incentive for the Australians to stress loyalty, support and caution to the British.⁴⁵⁴ This might even extend to providing reasons for decisions (e.g. the newly-mined gold retention policy, one-off sales of gold to the British) which were not the real ones. The RBA had scope for hidden action, both with respect to the Treasury, which was represented on the RBA's board but not the committees below it (and so did not see the FX dealings, only their aggregate effect), and also the UK. The focus is on internal communications. Fortunately, due to the London outposts of the RBA and Treasury, these records exist.

⁴⁵² Under an agreement with the BOE dating back to 1934: BOE:C40/174, Reading-Norman correspondence, 21/6/1934, 25/6/34; Kershaw, 5/6/1934

⁴⁵³ See Section 5/Annex 6 for NID/London funds

⁴⁵⁴ And also for the British practitioners at, say, the BOE to make similar reassuring noises to critics of the sterling area

Section 3: Australian reserves and diversification

This Section interprets the aggregate reserves data. It is appropriate when looking at Australia's aggregate reserves from a sterling perspective to focus on two assets, sterling and non-sterling.⁴⁵⁵ Because IMF credits are sometimes overlooked by the literature, these are shown separately as a third asset. It is clear from Figure 3 that gold and dollars increased gradually; sterling holdings fluctuated widely with aggregate reserves and the balance of payments (it played a transactional role); and the IMF reserve position, known as the 'IMF gold tranche', increased rapidly after 1961. The low in sterling holdings was around £200m (= A\$500m).

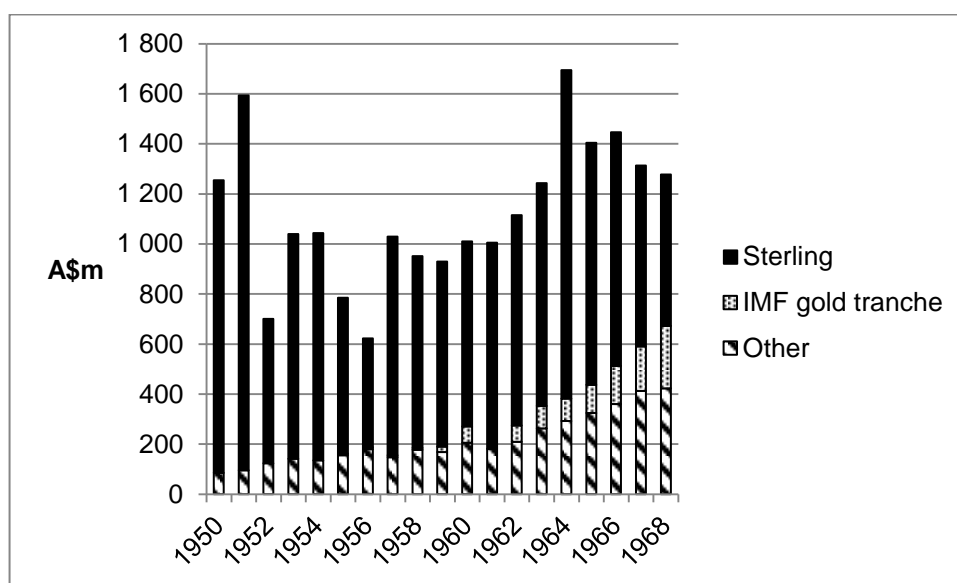


Figure 3: Australian central bank international reserves, divided into sterling, IMF gold tranche and other holdings, annually at 30 June, 1950 – 1968 (A\$m)

Source: RBA, <http://www.rba.gov.au/statistics/frequency/occ-paper-8.html>, 'Australian economic statistics 1949-1950 to 1996-1997, Occasional paper no. 8', 'Section 1: Balance of Payments', '1.18 [XLS] Official reserve assets and Reserve Bank foreign exchange transactions' (accessed 15 Feb 2015). Other comprises gold, US dollars and Deutschemarks

Note: The decline in sterling in 1968 is partly attributable to sterling's devaluation against the Australian dollar in Nov/1967, from A\$2.50 to A\$2.14. The low of sterling reserves reached in Q1 1961 is hidden by subsequent actions in Q2 e.g. a large IMF drawing

If confirmation were needed that Australia's balance of payments was the principal influence behind the RBA's sterling reserves, Figure 4 provides this. It shows changes in sterling reserves against the two principal elements in the Australian balance of

⁴⁵⁵ Non-sterling was gold and dollars only until the 1968 data point in Figure 3

payments, the current account (volatile and in deficit) and the non-official capital account (in increasing surplus). Figure 4 also displays the current account's percentage of GDP in three particularly negative years, to June 1952, 1961 and 1968.

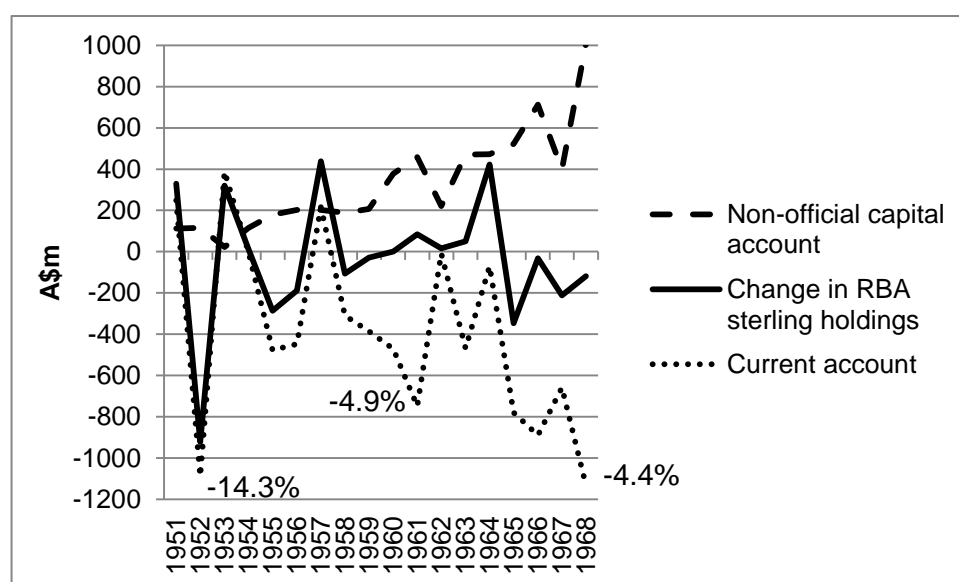


Figure 4: Annual change in Australian central bank's sterling reserves, and Australia's current and non-official capital account balances, years to 30 June, 1951 – 1968 (A\$m)
Source: RBA, <http://www.rba.gov.au/statistics/frequency/occ-paper-8.html>, 'Australian economic statistics 1949-1950 to 1996-1997, Occasional paper no. 8', 'Section 1: Balance of Payments', '1.1 Current account of the balance of payments', '1.15 Capital account and balancing item of the balance of payments', accessed 18/10/2017; Figure 3 for sterling reserves

The IMF gold tranche needs explanation. When other countries drew Australian dollars from the IMF in the 1960s, with Australia's encouragement, its gold tranche position was thereby increased. The gold tranche was liquidity at the IMF automatically available to Australia and considered by officials to be almost 'as good as gold'. Moreover, the drawer then usually sold the Australian dollars back to Australia for sterling, or used them to pay for Australian goods rather than with sterling. So invariably the drawing had a direct substitution effect, allowing Australia to diversify its reserves.⁴⁵⁶ That the gold tranche should properly be included in reserves is confirmed

⁴⁵⁶ For background to Australia's use of this technique, see RBA:BM-C-174, CBAC Memorandum, 2/8/1962; RBA:GHK-65-1, Aide Memoire, 15/7/1965

by the fact that the British negotiators at the time of the MSP agreement insisted that the MSP calculation should include it.⁴⁵⁷

From the data in Figure 3 it is possible to construct graph-lines of sterling's share of reserves, shown in Figure 5. Three versions of sterling's share are shown. The 'simple' share has been the measure used hitherto by the literature. It excludes the IMF gold tranche, and indicates gradual diversification, increasing slightly after 1964. Once the IMF gold tranche is included, as it should be, the second line shows an increased pace of diversification in the 1960s. The third version adds to this a thought experiment. It takes Schenk's observation about a £200m 'hard core' minimum sterling requirement in the 1950s, assumes that it continued in the 1964-8 period, and strips £200m out of the calculation since this holding is a given.⁴⁵⁸ Here the diversification appears dramatic. This is because aggregate reserves were in sharp decline in 1964-8, and the losses of reserves were all falling on the sterling holdings. Seen in this light, by the late 1960s, Australian officials were not showing much positive confidence in sterling's role as a reserve asset, over and above a minimum balance.

⁴⁵⁷ RBA:GDB-73-1, 'Definition of official reserves', 24/7/1968. Not surprisingly, statements by Australian politicians about their intention to keep their main overseas reserves in sterling ignored the IMF gold tranche

⁴⁵⁸ This deduction only of minimum sterling is justified on the grounds that gold and dollars did not have a transactional role (and the NID distribution of reserves matched that of the Central Banking Business – see Section 5)

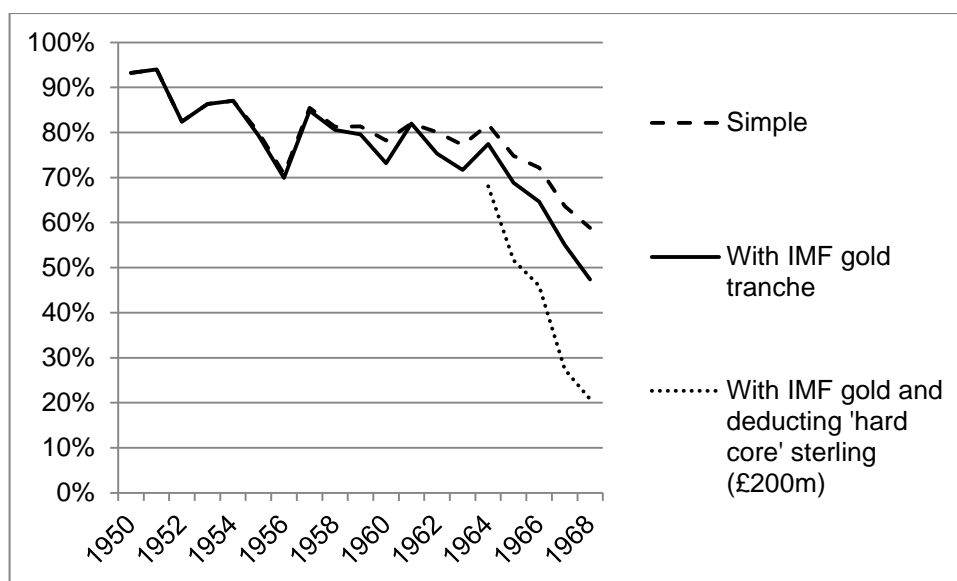


Figure 5: Sterling's share in Australian central bank international reserves, annually at 30 June, 1950 – 1968 (%)

Source: See data underlying Figure 3, author's calculations

Note: The decline in sterling in 1968 is partly attributable to sterling's devaluation against the Australian dollar in Nov/1967, from A\$2.50 to A\$2.14

What, then, was Australia's diversification policy? 'Sterling's share' cannot capture it because balance-of-payments movements influenced sterling's share. Sterling's share in effect conflates the spending of sterling for balance-of-payments reasons, and the deliberate switching of sterling into other currencies. In theory, as an independent country, Australia had a completely free hand to choose its mix of reserves. But because of operational practice and the transactional use of sterling, some of the changes in sterling's share may have been purely exogenous, e.g. due to an unplanned payments deficit (or surplus) falling on the sterling holdings, rather than an act of policy.

It is easy to strip out this balance-of-payments effect from the diversification picture. Australia was a sterling area member, and according to the British pooling rule, all changes in the balance of payments should have been reflected only in the sterling holdings. Therefore, ignore sterling holdings and focus only on non-sterling holdings. Changes in the non-sterling holdings indicate a breach of the pooling rule, an act of deliberate diversification.

There was also a constant element in Australian diversification from 1951: the unvarying policy of retaining all new gold production either in gold or dollar form.⁴⁵⁹ The rate of new gold production was around A\$30m per year. The policy was not welcomed by the British, from the pooling rule perspective it was a grey area, and it caused many diplomatic arguments, but ultimately it was accepted.⁴⁶⁰ It was part of operational normality.

This means that additional pro-active diversification, breaching the pooling rule, over and above gold production, can be derived as the difference between actual non-sterling reserves, and the path that non-sterling holdings would have taken if non-sterling reserves had increased at the rate of gold production. This is shown in Figure 6:

⁴⁵⁹ There is no reason to believe that the newly-mined gold retention policy was not followed to the letter, even if some of the accumulating pot of gold and dollars was later spent on specific items. For instance, the policy was referenced by an Australian Treasury officer in a memorandum in 1962: NAA:A571-1961/1966PART2, 'Distribution of international reserves' and 'Attachment: past policy...', appended to note, Daniel to O'Donnell, 'Financial implications...', 28/2/1962

⁴⁶⁰ TNA:T267/29, 'Sterling balances', p61

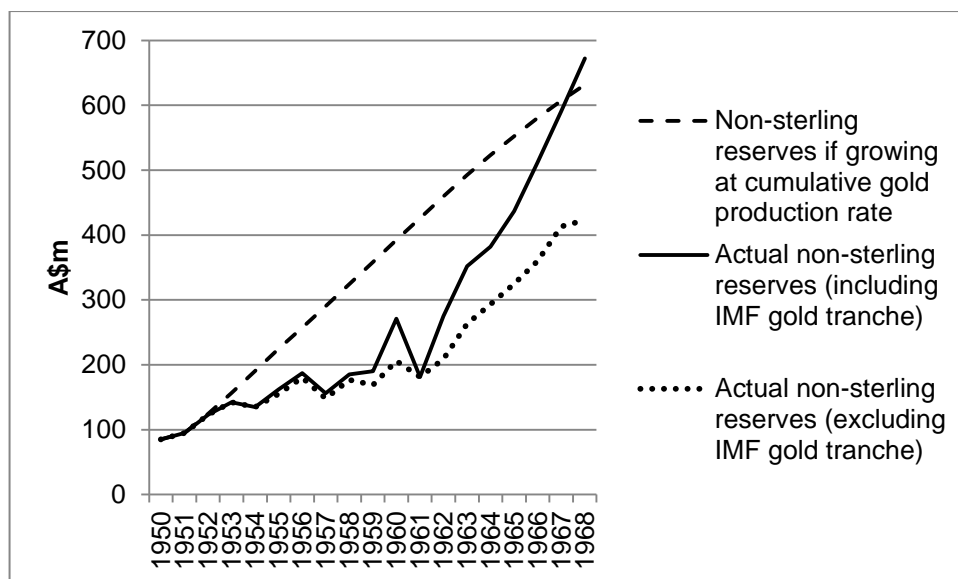


Figure 6: Non-sterling holdings, actual and hypothetical, in Australian central bank international reserves, including IMF gold tranche, annually as at 30 June, 1950 – 1968 (A\$m)

Source: Actual as for Figure 3, author's calculations; hypothetical based on annual gold production in Mudd, 'Gold mining in Australia'. The gold production is added from 30/6/1951 to the non-sterling holdings at that date. Gold production, presented in calendar year format in Mudd, is calculated as a two-year moving average for each June-June year and is converted into A\$ using a value of US\$35 per fine ounce and the US\$/A\$ exchange parity

Figure 6 presents a surprising finding about Australia's diversification. The dashed line can be interpreted as the course set by Australian policymakers when they made the deliberate decision in 1951 to retain all gold production in either gold or dollar form – on the assumption that Australia was in all other respects following the sterling area's pooling rule (an assumption to which we shall return). But, if that was the policy direction, Australia's actual reserves were blown significantly off that course. Actual non-sterling reserves were growing more slowly than the gold production rate until 1961. Given official policy that the value of all newly-mined gold should be retained within the central bank in the form of gold and dollars, this meant that Australia was in addition deliberately spending some of this, or switching gold and dollars into sterling – the reverse of the continuous diversification story in the literature based on sterling's simple share of reserves, and a puzzle that needs explaining.⁴⁶¹ After 1961, the

⁴⁶¹ Symons suggested how the divergence in the 1950s occurred. Some of the dollars from premium gold sales were being used to repay dollar maturities in this period. This was not surprising given that the publicly stated reason for the gold retention and premium gold sales policies had been dollar maturities, and given also the difficult discussions with the British over this issue. Australia also made additional

opposite was true. Actual non-sterling reserves were increasing faster than the gold production rate, and this was largely due to the IMF gold tranche (see the difference between the bold and dotted lines). Thus, from the perspective of the sterling area's pooling rule, Australia was actively engaging in deliberate diversification after that year. Over the whole period 1950-68, Australia diversified by little more than its gold production.

Section 4: Reserve management drivers: transactions, risk-return and the pooling rule

The aim of this Section is to try to untangle three different aspects of Australia's reserve management in the 1950s-60s: two economic drivers (the transactions – related to trade, debt and anchor currency – and mean-variance – i.e. risk-return – theories of central bank reserve management)⁴⁶² and the sterling area's pooling rule. In previous studies, the economic drivers have been in the foreground and the sterling area in the background. The aim is not to dispute the role of the economic drivers, but, by bringing the pooling rule into the foreground, to see if the latter mattered or had effects on reserve management. One challenge is how to distinguish the pooling rule from the transactional use of sterling, given sterling's role as an intervention currency arising from the sterling peg.

Let us start by interpreting, by way of hypothesis, the reserve management picture in Figures 3 and 6. Naameh described central banks as often dividing reserves into different sub-portfolios: one for liquidity and intervention, held in money market instruments; one for investment, held in bonds; and a 'rainy day' portfolio – in his example this was invested in SDRs and gold. According to Naameh, the liquidity portfolio would be subject to large and unpredictable cash withdrawals and injections, while the stable investment portfolio would seek yield and could partially hedge external currency liabilities.⁴⁶³ Although the RBA did not operate similar sub-portfolios, I believe that this model fits its reserve management well in this period, with some differences. Firstly, its entire stock of gold, dollars and IMF gold tranche were its rainy day fund – these assets were to increase over time with gold production, and were ordinarily not intended for sale, and they reflected, from the outset, a lack of confidence in sterling. Secondly, there was a 'minimum sterling' hard core

⁴⁶² For these economic drivers, see Soesmanto, Selvanathan and Selvanathan, 'Analysis'; Papaioannou, Portes and Siourounis, 'Optimal currency shares'; also the economic literature in Chapter 1

⁴⁶³ Naameh, 'Reserve management', pp149-50

transactional requirement of around £200m, most of which in time came to be invested in bonds, the equivalent of the investment portfolio. Thirdly, the rest of the sterling held was liquid and volatile, its de facto transactional currency, reflecting Australia's variable balance of payments. (As already noted, there is a subsidiary question in relation to the liquid part, whether the 100 per cent transactional focus on sterling was due to a sterling area pooling rule, or a sterling peg/intervention transactional driver). However, in a crisis, the 'minimum sterling' requirement was more important than the desire not to sell parts of the rainy day fund, and this explains how the 'rainy day' fund was blown off the course set in 1951 (see Figure 6).

Path dependence is where a pooling rule and the transactional use of sterling for sterling peg reasons can be distinguished. Following a crisis in which dollars have had to be sold to ensure minimum sterling holdings, and after the recovery of sterling reserves, the unconstrained reserve manager can quickly restore the assets in the rainy day fund by switching sterling back into dollars. But, under a pooling rule, that option is not available and the switch cannot be reversed quickly: non-sterling assets can only increase at the rate of gold production.

Before we get to this, however, it is important to understand how the accrual of gold and dollars worked at the RBA. As a result of the 1951 policy decisions, in effect, gold miners - the Gold Producers Association (GPA) - were given an option to sell any new gold production, at a profit to themselves, for US dollars on the international gold premium market. Under Australia's mobilisation controls, these dollars, and any residual unsold gold production, were retained by the RBA. Each month, the RBA's gold holdings would fluctuate through gold receipts arising from production less gold delivered to and sold by the GPA (and a small amount sold to industry): its gold holdings could *only* increase through residual unsold gold production. Given that it was selling gold on the gold premium market, Australia could hardly expect to use its

sterling or dollars to buy gold internationally. The GPA sale arrangements were also hard to change due to domestic politics around the mining industry.⁴⁶⁴ The RBA had many other opportunities to acquire dollars – through borrowing or through retaining any dollars being acquired daily under mobilisation – but until the 1960s it did not start to take those opportunities: so its US holdings would *only* increase through GPA sales of gold.

Where is the evidence? There were occasional references to the policy, e.g. in 1959 and 1965.⁴⁶⁵ But to verify this mechanism in practice over time, the reader may study relevant extracts from the RBA's board, over a two year period (1960-2) – see Annex 3. This period is chosen because the new RBA board reports explained the use of proceeds in detail, and it is interesting because one can discern changes of policy taking place as a result of the balance-of-payments crisis of 1960-1. There were four policy phases. From the start of 1960 until June, the policy was normal, as described above: since there were no GPA gold sales taking place in these months, the value of US funds hardly moved, while gold holdings gradually increased through gold production. The second, crisis, phase lasted from July 1960 to March 1961: now, in order to preserve sterling holdings, the proceeds of all GPA sales and maturing US Treasury bills were spent on 'current dollar requirements'; meanwhile part of the gold holding was sold to the Bank of England for sterling, and Australia also used its own gold to pay its IMF quota increase. As a result the US funds were diminished by 44 per cent and the gold holding by 23 per cent in this phase – a case of being 'blown off course' the normal policy direction. The third period, from April to August 1961, was one of post-crisis recuperation and restoration: there were heavy GPA sales, but the

⁴⁶⁴ These points were made in a RBA memorandum, which was considering how to increase gold holdings (RBA:BM-C-148, CBAC, 'Bank's Gold Holding', 15/12/1961)

⁴⁶⁵ In Mar/1959, the London office head referred to the current policy of 'drawing on the Sterling Area dollar pool for all our external currency requirements and still stockpiling our current gold production' (RBA:GJP-74-1, Evers-Phillips correspondence, 25/3/1959). Note that this was *after* the introduction of sterling convertibility in Dec/1958. Similarly, in Aug/1965, a note by Knight, Deputy Governor, described 'purchase of dollars for sterling' as 'the normal way of meeting current payments' in US dollars (RBA:IT-a-642-1, 'Investments in New York', Knight, 9/8/1965)

proceeds were largely directed to restoring the small 'working balances overseas'.

These were multi-currency balances, outside the central reserves, which the trading banks (acting as agents of the RBA), government and the RBA itself held.⁴⁶⁶

Consequently, neither US funds nor gold holdings increased by much in this period.

Finally, from September 1961 to January 1962, there was normality again: GPA sales proceeds augmented the US funds, and gold holdings increased through residual unsold gold production. These board reports showed that, under normal conditions, gold production and GPA sales *wholly explained* the increase in US funds and gold holdings. The divergence from normal post-1951 policy during the 1960-1 crisis (until August 1961) was noted in an RBA Investment Department memorandum in September 1962.⁴⁶⁷

Over the following three years this normal pattern continued (with one small amendment), although by 1963, the board reports were becoming less explicit about the use of proceeds.⁴⁶⁸ The pattern is shown in Figure 7 which plots the US funds and gold holdings from the beginning of 1962 up to the middle of 1965. The amendment to policy, consulted with the UK, was the new (mid-1962) decision to retain US dollar loan proceeds, but only on a temporary basis pending use of the proceeds: the plan was that the proceeds should all be spent over nine months.⁴⁶⁹ This policy augmented US funds by A£12.9m in July 1962, and by A£10.9m in November 1962 (see the blips

⁴⁶⁶ At end-Mar/1961, total working balances overseas, including sterling, being outside the central reserves, stood at A£52m compared with A£336m for the central reserves (RBA:BM-C-165, CBAC, 'Net Gold and Foreign Exchange Holdings', 24/5/1962). Arndt in 1960 said that most of the trading banks' working balances were items in transit or similar, and were thought to be no more than £10m at the core, while the RBA 'meets all net dollar payments and receives all net dollar receipts arising from the trading banks' business' (Arndt, *Australian trading banks*, pp109-10). I could not find a figure for the amount of working balances overseas held in US dollars, but it is reasonable to assume that these had been depleted in the same way that the US funds were depleted during the crisis period, or that the transfers reflected uncertainty about the need for current spending requirements. That dollar working balances were small was confirmed by Arndt, *idem*, p110, Snape, 'A foreign exchange market', p301, and a board paper in Nov/1967: 'the high proportion of present non-sterling trade is being comfortably handled on very small working balances' (RBA:BM-Pe-87, 'Overseas funds...November 1967', 'Points to make...')

⁴⁶⁷ RBA:BM-C-181, CBAC Memorandum, 'Premium Sales of Gold', Investment Department, 20/9/1962

⁴⁶⁸ RBA:BM-Pe-23 to -62, Board Memoranda, 'Investment of Overseas Funds'

⁴⁶⁹ RBA:BM-C-177, CBAC Memorandum, 'Central Bank Investments in U.S.A.', Investment Department, 29/8/1962. The memorandum said that less than six months would 'perhaps appear undignified' and more than a year would be 'tending to take it beyond a temporary holding', suggesting an artificiality about the selected run-down of nine months

upwards in Figure 7), but the ‘run-off’ of these ‘temporarily invested proceeds’ was ‘virtually completed’ by April 1963. In May 1963, there was another dollar borrowing raising A£12.3m equivalent, less A£5.8m contributed by the RBA for an IMF repurchase by the government.⁴⁷⁰ But again, due to the spending of these proceeds, there was little net accumulation of dollars from the loans.

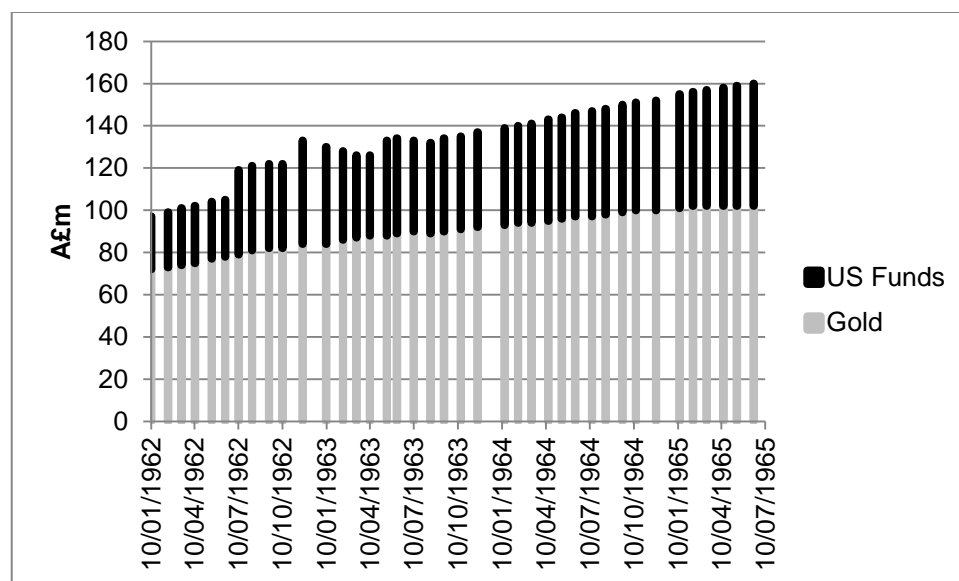


Figure 7: Holdings of US funds and gold, as reported to the RBA board, 10 January 1962 – 16 June 1965 (A£m equivalent)

Source: Extracted from RBA:BM-Pe-23 to -62, Board Memoranda, ‘Investment of Overseas Funds’

Gold production was thus dictating the increase in the RBA’s holdings of gold and dollars. Figure 8 verifies this by comparing the change in the latter against the former, between board meetings (the data stop at October 1964 because the gold production receipts information became less precise in subsequent reports). Apart from the three above-mentioned borrowing events and their spending effects, which are clearly visible, the co-movement between the two variables was almost exact. Thus under normal conditions, with this small variation around US dollar borrowing (all other currency borrowings still being converted to sterling), transactional needs such as ‘current dollar requirements’ continued to be sourced from sterling holdings: the operation of a pooling rule.

⁴⁷⁰ These facts were in RBA:BM-Pe-23 to -62, Board Memoranda, ‘Investment of Overseas Funds’. The phrases cited are from the relevant report

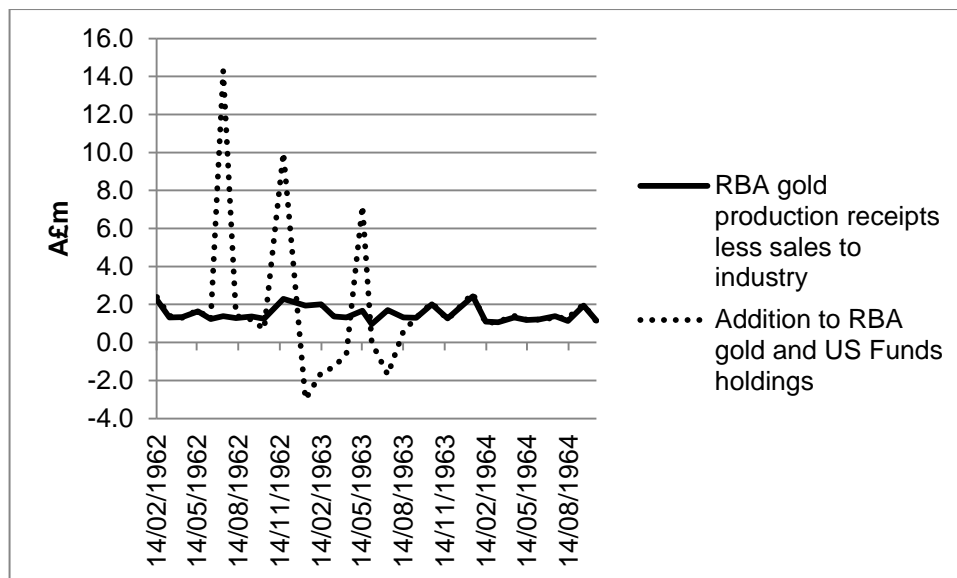


Figure 8: Comparison of gold receipts and additions to gold and US funds holdings, as reported at RBA board meetings, 14 February 1962 – 14 October 1964 (A£m)

Source: Extracted from RBA:BM-Pe-23 to -54, Board Memoranda, 'Investment of Overseas Funds'. Gold production converted into US dollars at US\$35 per fine ounce, and then into Australian pounds at an exchange rate of A£1 = US\$2.24

All very well, but surely this pattern arose, not because of a pooling rule, but because of the sterling peg? The RBA simply had to intervene to stabilise the rate of Australian currency against sterling, and what was needed to do this was sterling, which consequently fluctuated with the balance of payments. Yes, gold and dollars were also held and accrued for precautionary risk-return reasons in the automatic fashion described, but this was because they could be converted into sterling, the intervention currency, which dominated everything. Was this not so?

One cannot exclude this possibility, which one might call 'rational intervention' arising from the sterling peg. If the peg/intervention dominated everything while gold production was treated separately, the two patterns of reserve management behaviour (a pooling rule, or rational intervention) are indistinguishable. And there have been country examples where a commitment to a currency peg has wholly dominated

reserve holdings.⁴⁷¹ But there are three problems with the argument. The first is that it offers no coherent reason why gold production was being treated separately: why currency borrowings were being converted into sterling, but the proceeds of GPA gold sales and residual gold production were not. The pooling rule does provide an explanation for this behaviour: it was a concession to the rule accepted by the UK. Secondly, this is not the way Australia's diversification has been explained by economic historians. For example, Singleton and Schenk majored on other transactional factors – debt and trade – as drivers for diversification, and the three Australian constraints on diversification (by contrast, intervention was mentioned only briefly). The third problem is related to the second, and theoretical: if sterling intervention dominated everything, where does this leave trade and debt as widely acknowledged drivers of transactional holdings? In fact, when we try to apply this 'rational intervention' argument to Australia's case, we find examples where Australia's behaviour was inconsistent with the transactions theory of reserve management (but not with the pooling rule). The whole point of the transactions theory is that central banks seek to avoid unnecessary or costly FX transactions.⁴⁷² Given that Australia was a direct spender of dollars, a natural 'transactions theory' response ought to have been to retain, regularly, the proceeds of dollar borrowings or other gross dollar receipts and actually to use them to service the dollar spending.

This can be shown by looking at the monthly reports from the central bank's London office about the London funds. These reports, for a few years from 1954, gave a detailed monthly breakdown of the transactions in which sterling was involved, both within the 'Central Bank' and also within the CBA's 'Trading Bank', which operated as a competitor to other Australian trading banks and was accounted separately from the 'Central Bank' after 1953. Example photographs of these figures, kindly provided by staff at the RBA Archives, are in Annex 4.

⁴⁷¹ Hansen, Olgaard and Jensen, 'Risk management'

⁴⁷² For a statement of the theory, see Dooley, Lizondo and Mathieson, 'Currency composition', p398

It is important to understand that what was happening was no ordinary FX intervention. It was mobilisation. There was no foreign exchange market in Australia, nor was there an FX market in Australian currency in which the central bank could 'intervene' outside Australia. There was just the CBA's fixed price for the Australian currency against sterling (which determined its price against other currencies) and the Australian trading banks' fixed (and profitable) bid-offer rates, acting as agents around the central bank's price.⁴⁷³ In the central bank's case, the values given in Annex 4 are dominated by domestic Australian counterparties (trading banks and government entities) and represent FX transactions between Australian pounds and sterling. The only exceptions were specifically designated 'currency transactions', namely between sterling and US dollars (telegraphic transfers with New York), and between sterling and Canadian dollars (telegraphic transfers with Ottawa).⁴⁷⁴ The Trading Bank was also largely dealing with domestic counterparties. Figure 9 shows the monthly breakdown of net movements (receipts less payments) in some of the major flow categories affecting the central bank's London funds up to the end of 1956. It is clear that the central bank at this time was immersed in sterling transactions, 'currency transactions' mainly involved net spending of sterling, and the London funds were largely driven by the transactions with the Australian trading banks.

⁴⁷³ Snape, 'A foreign exchange market'. As late as 1970, overseas FX markets in Australian dollars, 'shadowing' the trading banks' wide fixed bid-offer rates, were described as 'embryonic' (p300)

⁴⁷⁴ Note from Annex 4 that in each month there were gross payments and receipts in these currency transactions – no obvious short run netting off and holding of US dollars or Canadian dollars by the central bank in order to economise on FX transactions

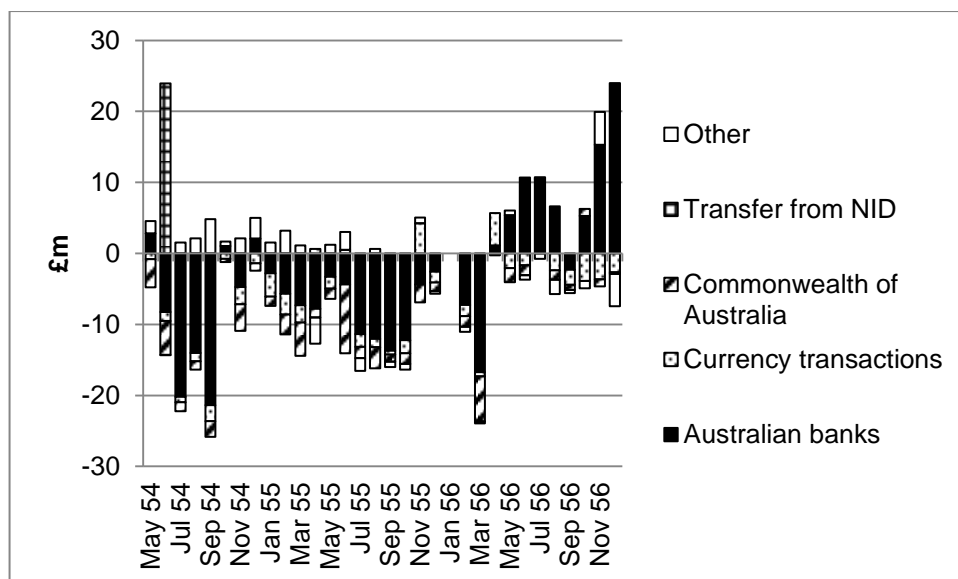


Figure 9: Monthly net movements in CBA's London funds, selected components, from Monthly Reviews from London office, May 1954 – December 1956 (£m)

Source: RBA:C.3.20.1.19-1, C.3.20.1.19-2, C.3.20.1.20-1, Tables, 'Central bank', 'Movement in funds', 'Principal transactions'

Note: No such table available in January 1956 Monthly Review. Transfer of sterling from Note Issue Department (NID) is discussed further in Section 5

Given this pattern of spending dollars, converting dollar borrowings – indeed all borrowings – into sterling (a consistent policy until 1962 as discussed above) made little sense from the perspective of transactions theory. This can be seen by focusing on Canadian dollar transactions against sterling. Figure 10 shows the gross receipts and payments from these transactions until the end of 1956.

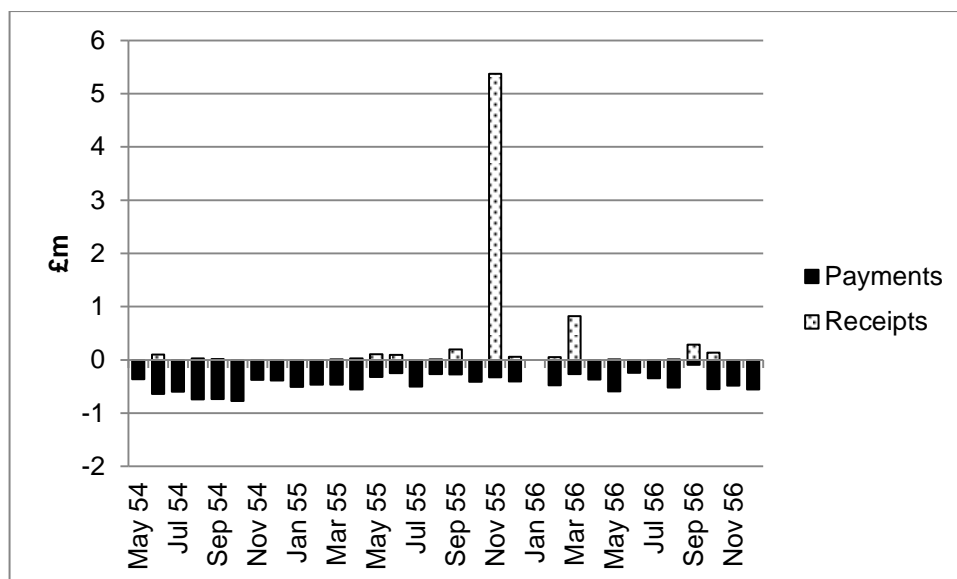


Figure 10: Currency transactions of CBA, gross payments and receipts of sterling against Canadian dollars, from Monthly Reviews from the London office, May 1954 – December 1956 (£m)

Source: RBA:C.3.20.1.19-1, C.3.20.1.19-2, C.3.20.1.20-1, Tables, 'Central bank', 'Movement in funds', 'Principal transactions', 'Currency transactions', 'T.T. Ottawa'

Note: No such table available in January 1956 Monthly Review

Canadian dollar-sterling transactions were predominantly gross payments to meet Canadian dollar spending needs. The outlier November 1955 receipt was the exchange of Canadian dollar borrowing proceeds for sterling. The London correspondent reported to Sydney how hard it was to transact this amount in Canadian dollars in London without moving the market, and how the Bank of England had assisted in the transaction.⁴⁷⁵ But, according to the transactions theory, this conversion was an unnecessary transaction: the Canadian dollars could have been retained to meet the Canadian dollar spending needs, in effect avoiding that and the ensuing FX transactions.⁴⁷⁶ Indeed, it might be asked: if sterling had been the only transactional currency for peg/intervention reasons, and Australia had not had access to the pool, how would it have funded the Canadian dollar payments, without retaining the Canadian dollar proceeds? In this sense, the 'rational intervention' argument relies on Australia's access to the pool. The point is that, through mobilisation of all currencies

⁴⁷⁵ RBA:C.3.20.1.19-2, From London—File 2—1955, 'Monthly review', Nov/1955

⁴⁷⁶ This example is illustrative. Obviously the optimal decision depends on relative interest rates versus dealing costs, and the level of sterling reserves (given the need to maintain minimum sterling holdings). But London funds were not at this point at a critically low level. They stood at £140m at end-Oct/1955, before this exchange occurred (see Figure 16). And the conversion of borrowings and other currency receipts into sterling was a consistent policy

and gold into the central bank, the RBA had ample means, motive and opportunity to optimise its FX transactions, but (until the very limited measures taken in 1962) it refrained from doing so. It was only in August 1965, after the rejection of its request for a guarantee from the Bank of England, when the central bank began, occasionally, to break with its normal FX practices. In August 1965, when recent dollar loan proceeds began to be spent by the government according to the 1962 'temporarily invested proceeds' formula, the RBA unusually topped back up its US funds by buying more US dollars with sterling.⁴⁷⁷ In September 1965, it bought US dollars from Australian trading banks, dollars which would normally be sold for sterling, and instead added US\$7m to its US funds.⁴⁷⁸ But these unobtrusive transactions were the exception, not the rule.

Let us return to the big picture. We need to see if the pooling rule, clearly evident in board reports and correspondence of 1960-5 and London office correspondence in the mid-1950s, was relevant for Australia across 1950-68 as a whole. The alternative hypothesis is that the actual path for non-sterling reserves seen in Figure 6 could be explained perfectly by a combination of transactions and risk-return factors. We begin with a review of these motives.

It is in practice impossible to make anything other than a qualitative judgement about the RBA's assessment of the risk in holding sterling in this period of fixed exchange rates. (Section 6 addresses this qualitative judgement, examining RBA papers). An interest rate differential of, say, 2 per cent per annum would offer minimal ex-ante protection against an imminent devaluation, so it is the perceived risk of devaluation that matters primarily, which presumably varied over time, becoming heightened during sterling crises. But it is clear from Annex 2 that smaller countries which were concerned about sterling – such as Burma in 1964 or Singapore in 1967 – could diversify from sterling rapidly. There were also certain assets that by definition must

⁴⁷⁷ RBA:IT-a-642-1, 'Investments in New York', Knight, 9/9/1965

⁴⁷⁸ RBA:IT-a-642-1, 'Dollar dealings', Banking Department, 2/9/1965

have been held for risk-return reasons, because they did not have a transactional role. The IMF gold tranche provided Australia with risk diversification but it was not a transactional holding: it could only be utilised by drawing from the IMF, which Australia only did in extremis during crises, e.g. in 1952 or 1961. Gold was probably also held more for risk-return than for transactional reasons. A paper for CBAC in December 1961 argued:

‘There have always been a number of reasons for our desire to hold gold, probably the most significant of which has been to provide our reserves with some protection in the event of a devaluation of the £ Stg. or U.S. dollar’⁴⁷⁹

It is true that the official reason given in 1951 for retaining gold production, and then dollars from GPA sales, was to support or repay IMF drawings and dollar borrowings by Australia (a transactional explanation), but close study of the government files reveals that this was a polite fiction: in fact Australian officials were very concerned about what the British and Americans were then planning to do to Australia’s large sterling holdings in order to resolve the UK’s post-war debt problem. Retaining gold production was the policy response (the decision was driven by perceptions of risk).⁴⁸⁰

Sensitivity to risk-return issues is sometimes associated with profit-driven commercial banking, rather than state-owned central bank, corporate arrangements. I could find no evidence of a change in attitude to risk and return arising from the transition from the CBA, with its combined commercial departments, to the RBA, a pure central bank, in

⁴⁷⁹ RBA:BM-C-148, CBAC Memorandum, ‘Bank’s Gold Holding’, Dec/1961

⁴⁸⁰ ‘Approaching maturities of dollar loans’ had been a reason given by the Australians to the British for the decision to retain gold production from Mar/1951 (TNA:T267/29, ‘Sterling balances’, pp60. See also Bury’s 1953 similar remarks, including that it was too much to expect every sterling area country to rigorously observe the rules, cited in idem, p61 and Schenk, *Britain*, p31. Australia’s letter to Attlee can be found in TNA:T236/4648, Harrison-Attlee letter, 27/3/1951). However, Australia in reality made the decision because it feared British blocking or other action against its then large sterling balances (NAA:A9564,130/3,11527393, Wheeler-Fadden letter, and memorandum, ‘Australia’s international reserves’, 12/3/1951). ‘Sterling balances’, not dollar maturities, was also the principal reason for the change recorded by the BOE (TNA:T236/4648, Cobbold to Brittain, 28/3/1951). In any event, ‘approaching maturities’ should not have led to an accumulation of gold and dollars, as Symons observed (TNA:T267/29, ‘Sterling balances’, pp60-1)

1960.⁴⁸¹ This is because already, as a consequence of the 1930s depression, the Second World War, and the 1945 legislation, the state-owned CBA was not, in fact, a commercial bank with some central bank functions, but rather a central bank which was being encouraged to provide more commercial services on behalf of the state – a ‘socialist competitor’, to cite Governor Coombs’ chapter heading.⁴⁸² Even by the mid-1930s, as Schedvin argued, ‘the Commonwealth Bank was beginning to resemble a central bank’,⁴⁸³ and in 1945, it was given a formal central banking mandate to pursue, on behalf of the Australian people, currency stability, full employment, economic prosperity and welfare, to work closely with the Treasury and to accept the government’s ultimate authority.⁴⁸⁴ The retained profits of its trading business in the 1950s were small (a little over A\$0.5m per annum), while there was little change in the profit accruals to reserves of the Central Banking Business over this transition (from average A\$7.4m in 1957-9 to average A\$5.5m in 1960-2).⁴⁸⁵ Moreover, the CBA’s Governor Coombs was first and foremost a public servant, whose ‘central concerns were about power and social justice... maintaining adequate control over an inherently unstable economic system’.⁴⁸⁶ This is confirmed by a reading of Coombs’ memoir and Schedvin’s central bank biography.⁴⁸⁷

Both before and after 1960, I found references to risk and return. In the London office’s ‘Monthly Review’ in the 1950s, the correspondent often reported the successful prices achieved by the office in executing the Governor’s cabled instructions, and also provided market information and gossip. In the August 1957 review, he gave

⁴⁸¹ The principal profit distribution change in 1960 was as follows. Since 1945, and also under 1953 legislation, ‘Central Bank profits were divided equally between the Reserve Fund and the National Debt Sinking Fund’; under the 1959 legislation, ‘Central Bank profits, after payment to the Reserve Fund of an amount determined by the Treasurer after consultation with the Board, [also] go to the Commonwealth’. Profits of the NID went to the Commonwealth government under both regimes. Citations are from RBA:BM-Pe-3, Board Memorandum, ‘Distribution of assets...’, Mar/1960. See also White, *Australian banking*, pp13-18, 62-4

⁴⁸² Coombs, *Trial balance*, p121

⁴⁸³ Schedvin, *In reserve*, p54

⁴⁸⁴ Schedvin, *In reserve*, pp63-4. Linklater, *Inside the Bank*, pp24-33, sets out succinctly the timing of the CBA’s transformation into a central bank

⁴⁸⁵ White, *Australian banking*, pp62-4

⁴⁸⁶ Schedvin, *In reserve*, p291

⁴⁸⁷ Coombs, *Trial balance*, pp121-82, Schedvin, *In reserve*, pp62-71, 144-66, 271-94

information about a simple FX arbitrage being promoted to them by an American bank in London – selling sterling spot against dollars and buying it forward. Despite the bank's siren offer of 'delectable profits that could be ours for the asking', the correspondent's purpose was solely to provide information. There was no suggestion that the trade should actually be undertaken, and indeed London's reaction had been to contact, unofficially, a Bank of England officer, who had confirmed that 'such swaps for quick profits were contrary to the spirit of the regulations'.⁴⁸⁸ In evaluating the relative attraction of gold, sterling and US dollars in March 1959 (a time when sterling looked strong on the exchanges against the dollar), Eyers, the London head, wrote to the head of the Investment Department, arguing that Australia should hold gold 'to the maximum extent'. Based on five factors, transactions requirements, risk, return, transactions costs and, lastly, disclosure (the need, in the case of sterling, to 'show our hand' to the UK authorities), he gave a balanced view on the holding of sterling or dollars, 'though the answer depends to some extent on the weight one would give to the last point'.⁴⁸⁹

A board paper in January 1965 by the Investment Department described three attributes of the reserves: 'a Reserve Fund' (liquid holdings to support balance-of-payments needs), 'Security' (risk) and 'Earnings' (returns). The case was being made for longer-term investment of the 'hard core' (minimum) sterling reserves in pursuit of higher yields.⁴⁹⁰ This was an elaboration of a proposal that was referenced at the September 1964 board, in which the Governor's 'aide memoire' ended: 'we will, of course, consult the Bank of England'.⁴⁹¹ In the 1960s, risk-return sensitivity emanated particularly from the Investment Department, whose heads, first Phillips, then Knight, both future Governors, pushed strongly for diversification from sterling. Sensitivity in particular to risk may have been generated by the Governor's difficult relationship with

⁴⁸⁸ RBA:C.3.20.1.20-2, 'Monthly Review', From London, Aug/1957

⁴⁸⁹ RBA:GJP-74-1, Eyers-Phillips letter, 25/3/1959

⁴⁹⁰ RBA:BM-Pe-56, 'Attachment...', 'Investment of overseas funds', Investment Department, 21/1/1965

⁴⁹¹ RBA:BM-Pe-53, 'Aide memoire', 'Investment of overseas funds', Investment Department, 29/9/1964

Treasury Secretary Wilson, who fought his corner hard: Wilson was determined to ensure that the RBA should not earn profits which properly belonged to the government, but equally seemed reluctant to underwrite the Bank's risks. This is illustrated by a Treasury-Bank negotiation in August-September 1961 over the profits arising from the 1961 IMF drawing, which was converted into sterling. Instead of explicitly replying 'no profit – no loss' in response to Wilson's expectation that all the profits should be paid to the Treasury, the Governor's diplomatic approach in this case was to continue the 'Uniform Proportionate Distribution' (UPD) of assets between the Central Banking Business and the Note Issue Department (the latter's profit/loss was entirely for the government, and for technical reasons the UPD effectively directed more sterling there – of which more later).⁴⁹² Loss aversion at the RBA was also reflected in a decision to apply annual FX profits towards a 'currency fluctuation reserve', which had reached A\$96m by July 1967.⁴⁹³ (Sterling's November devaluation reduced the value of reserves by about A\$113m, against savings of about A\$108m from Commonwealth and State debt denominated in sterling).⁴⁹⁴ In summary, it seems from correspondence and debates that both pre-1960 CBA and post-1960 RBA were primarily concerned with reducing portfolio risk and avoiding loss.

Turning to transactions motives, which are mainly relevant to sterling and dollar holdings, these have been widely attributed in theory to the currency peg, currency orientation of trade, and currency denomination of debt.⁴⁹⁵ It is possible to create a basic 'transactions index' for Australia by assigning reasonable assumed weights to these three factors and comparing the implications of the index with actual holdings of dollars (or of dollars and gold, on the alternative, though less satisfactory, assumption that gold might have been held as some kind of transactional dollar-substitute).

Papaioannou, Portes and Siourounis found that in a mean-variance framework, the

⁴⁹² RBA:BM-Pe-138, BM-Pe-141, BM-Pe-142, re International Monetary Fund drawing

⁴⁹³ RBA:BM-Pe-83, Board Memorandum, 'Currency fluctuation reserve', 5/7/1967

⁴⁹⁴ RBA:BM-Pe-94, Board Memorandum, 'The devaluation of sterling', 3/7/1968

⁴⁹⁵ The principal reference being Dooley, Lizondo and Mathieson, 'Currency composition'

currency peg was substantially more important than transactions costs, the direction of trade and the currency composition of debt.⁴⁹⁶ Meanwhile other authors have broadly given equal billing to the trade and debt factors,⁴⁹⁷ and we need to address Singleton and Schenk's debt and trade diversification argument. A weighting of 50-25-25 for peg-trade-debt is therefore suggested.

Figure 11 shows this transactions index and its component parts, expressed as sterling's share of currency reserves, predicted by the assumed transaction factors. The calculations of the trade share index and debt share index are provided in Annex 5. The 1968 values for these were obviously affected by sterling's devaluation.

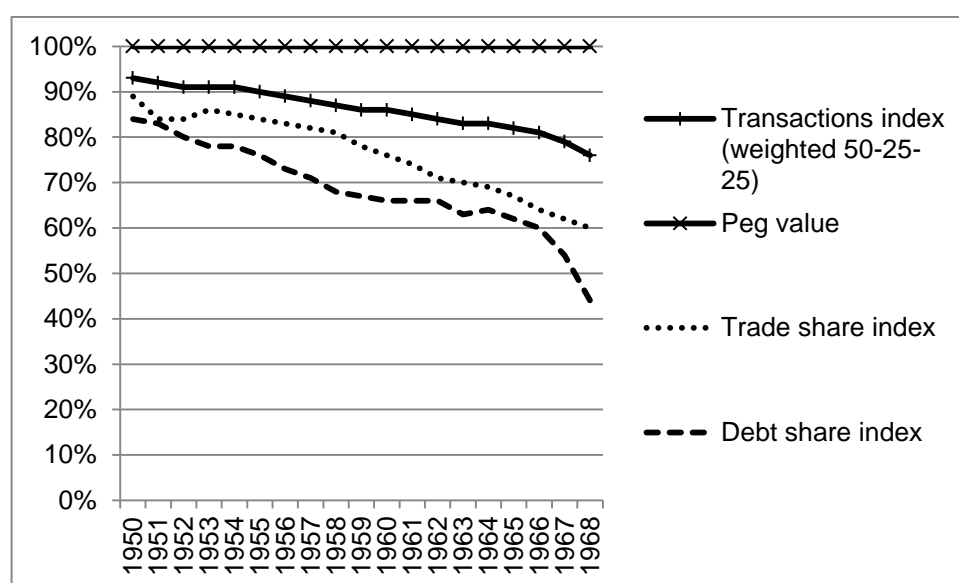


Figure 11: Australia transactions index and its component sub-indices, as at 30 June, 1950 – 1968 (%)

Source: Author's calculations, see Annex 5

It can be seen that this transactions index, declining from 93 per cent to 76 per cent, gives predicted sterling share values that are *above* the actual sterling shares (of

⁴⁹⁶ Papaioannou, Portes and Siourounis, 'Optimal currency shares', p516

⁴⁹⁷ Eichengreen and Mathieson, 'Currency composition'

currencies and gold),⁴⁹⁸ which declined from 93 per cent to 59 per cent over the same period (see Figure 12). In making this comparison, however, allowance needs to be made in the actual sterling share line for the low sterling reserve years of 1952, 1956 and 1968, so the lines are closer than they seem. Indeed the relatively high sterling currency trade share of Australia – Australia’s ‘immersion’ in sterling transactions, as already highlighted in the London funds data – is an important finding of this paper, with new evidence reviewed in Section 5 and Annex 5. The transaction index values are obviously sensitive to the weights apportioned to the peg, trade and debt, but changing the weights from 50-25-25 to 40-30-30 would only shift the 1968 value downwards from 76 per cent to 71 per cent, and there is broad consensus in the economic literature about the primacy of the currency peg as a transactions factor. Figure 12 suggests that, from a transactions perspective alone, the pooling rule was not a particular constraint – the transactions background may not have been changing as fast as Singleton and Schenk suggested, and gold production gave Australia ample opportunity to diversify.

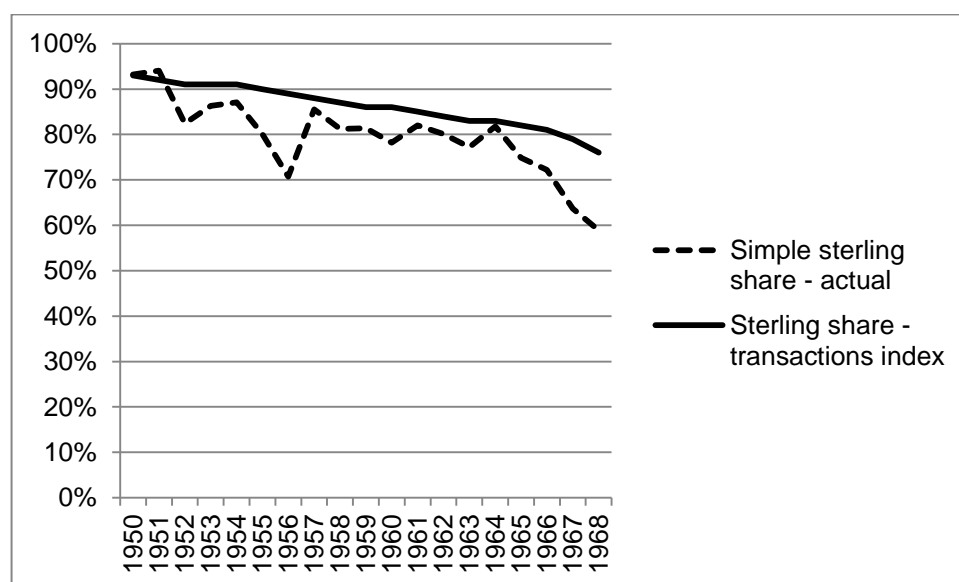


Figure 12: Sterling’s percentage share of Australian central bank’s international reserves, actual and transactions index, 30 June, 1950 to 1968 (%)

Source: Figure 5 for actual, Figure 11 for transactions index

⁴⁹⁸ The IMF gold tranche can be left out of this part of the discussion, as it was plainly not a transactional holding

A higher transactions index than actual sterling share seems reasonable, since, as Singleton and Schenk argued, Australian officials were also concerned about the risks for sterling arising from British economic policies, meriting additional precautionary holdings of gold and dollars. However, if, instead, and more plausibly, dollars alone are treated as the alternative transactions currency, the results implied by the transactions index are far from satisfactory: actual dollar holdings were significantly lower than those predicted on transaction grounds, even before considering the need for extra precautionary dollar holdings. This is shown by Figure 13, which sets out the actual and predicted holdings of dollars. While the shape looks broadly consistent, the magnitude is not. Again, in looking at the dotted (predicted) line, one should discount the low years for reserves (1952, 1956, 1968) since sterling holdings were under pressure and affecting the appetite for dollar reserves.⁴⁹⁹

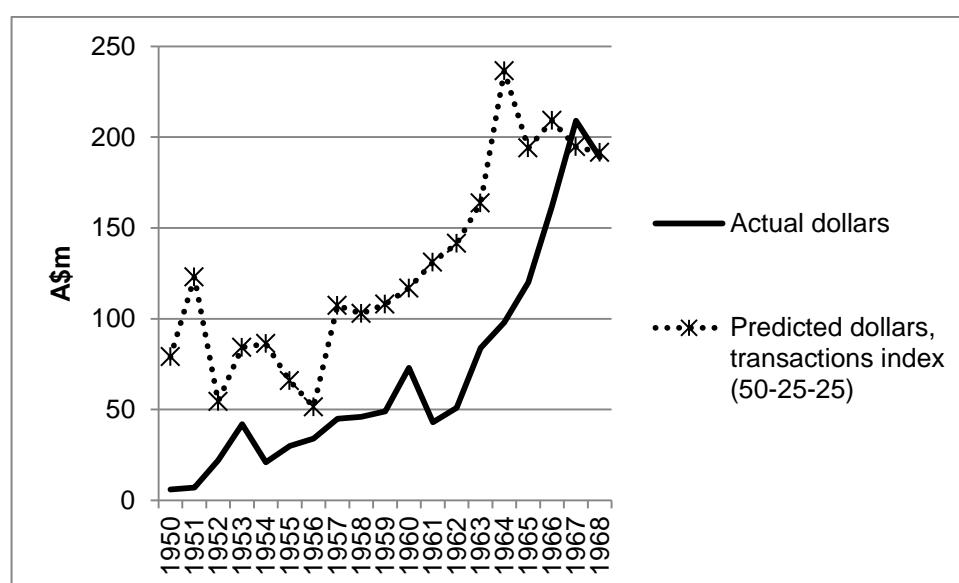


Figure 13: US dollar international reserves, actual and predicted, using transactions index, as at 30 June, 1950 – 1968 (US\$m)

Source: Data underlying Figure 3 for actual; for predicted, calculated using the following formula: (holdings of sterling and US dollars) x (1-transactions index)

Finally, we can make a simple comparison of the effectiveness of the pooling rule against transactional factors in 1950-68. Given Australia's significantly underweight transactional position in dollars (Figure 13), it is better for the transactional argument to

⁴⁹⁹ Whether one should ignore the high years (1951 and 1964) is moot. It could be argued that high sterling reserves should not alter the transactional appetite predicted by the transactions index. If one believes that transactions demand is 100% currency peg, one should say so explicitly.

assume that gold was also acting as a dollar-substitute. One can examine annual actual changes in gold and dollar holdings against those predicted by the pooling rule and by the transactions index. Here the pooling rule is a constraining factor: the annual increase in gold and dollars cannot be more than gold production. However, the reserve manager motivated by the transactions index is a free agent, and can make any size investment or divestment relative to last year's actual holdings. The results are in Figure 14.

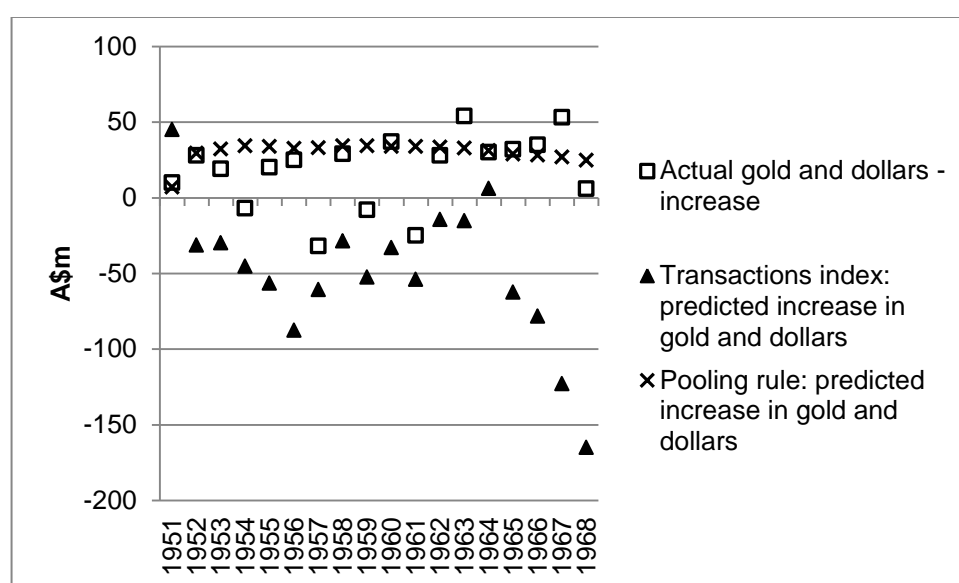


Figure 14: Annual increase in gold and US dollar reserve holdings, actual and predicted (by transactions index and pooling rule), years to 30 June, 1951 – 1968 (A\$m)

Source: Actual increase: calculated from data in Figure 3. Predicted by transactions index: calculated (from data in Figure 3) according to the following formula, (sterling, gold and US dollar reserve holdings) \times (1-transactions index) – (actual gold and US dollar holdings one year earlier). Predicted by pooling rule: annual gold production (data from Figure 6).

The transactions index (triangles) under-predicted actual increases in gold and dollars (squares) by variable margins, even after ignoring the crisis years (to June 1952, 1956 and 1961). If the difference was accounted for by precautionary risk-return holdings, one would have expected that difference to increase gradually over time in line with increasing concerns about sterling, not to fluctuate so much. By contrast, the pooling rule (crosses) explains the actual changes in gold and dollars (squares) remarkably well. There were years when the actual increase in gold and dollars was much less

than gold production – e.g. particularly the data points for the years to June 1954, 1957, 1959 and 1961 in Figure 14. However, as will be seen in Section 6, the accounting years to June 1953, 1956, 1957, 1959 and 1961, saw sales of gold or dollars in order to shore up sterling holdings, so such shortfalls were to be expected. Moreover the years 1952-4 saw major dispute between the British and Australians over the latter's gold retention policy,⁵⁰⁰ and in 1953-5 Australia also repurchased the dollars it had drawn from the IMF in 1952,⁵⁰¹ so there was reason and opportunity to make one-off concessions to the British around that time. Overall, the process was path dependent: large shortfalls were not restored the following year. Interestingly, there were only two years (to June 1963 and 1967) in which the actual increase was significantly more than that predicted by the pooling rule. The June 1963 figure can largely be explained by the May 1963 dollar borrowing already mentioned in this Section. The heightened diversification in the 1965-8 period will be discussed in Section 6. In summary, apart from the IMF gold tranche and the leeway provided by gold production, the pooling rule looked like a consistent policy – a rule that was broadly followed – even into the 1965-8 crisis period.

To summarise this Section: Australia closely followed a pooling rule. A pooling rule explains Australia's reserve management better than other alternative explanations. Because of reserve pooling, its 'transactional' reserve holdings were almost entirely in sterling form; and all its sterling holdings were transactional (save for minimum sterling holdings, which, as we will see, were themselves motivated by the risk of adverse transactions). By the same token, its holdings of gold, dollars and IMF gold tranche were not transactional, but precautionary and mainly held for risk-return reasons.

⁵⁰⁰ TNA:T267/29, 'Sterling balances', pp60-1

⁵⁰¹ Horsefield, 'Charges, repurchases', pp460, 464

Section 5: Peg, pool and other effects of the sterling area on Australia's reserve management

The previous Section provided evidence for the pooling rule that Australia was following. This Section does two things. Firstly, it demonstrates that Australia valued membership of the sterling area, and discusses the macroeconomic benefits of, and attitudes towards, the sterling peg and pooling arrangements. Secondly, it broadens the discussion of the effects of Australia's sterling orientation on its reserve management, identifying seven specific effects.

That Australian officials valued membership of the sterling area is not controversial. Even the RBA, arguing for diversification from sterling in July 1968, admitted in relation to past sterling area pooling and exchange controls:

'Despite the restraints on freedom of action entailed in these arrangements, membership of the sterling area may have allowed Australia to achieve levels of trade and capital inflow higher than would have been possible if we had followed a more independent line of action'⁵⁰²

The pool had risk-sharing, trade-enhancing and cost efficiency benefits for Australia. This was recognised in the literature of the time.⁵⁰³ Specifically, Wright argued that Australia was a net drawer on the dollar pool in the years 1946-52 (except for 1950-1)⁵⁰⁴ and Bhagat showed the same for 1948-58.⁵⁰⁵ Kamarck replied (to Wright) that

⁵⁰²RBA:BM-Pe-94, Board Memorandum, 'Disposition of international reserves', 3/7/1968. This paper described the dollar pool as ending with convertibility in 1958, and this might be a source of confusion about when pooling ended. However, the previous Section, and documents covered in this Section, show that nothing changed for Australia in 1958. Gifford et al, *Australian banking*, described the then current (1967) operation of the 'informal but strict "pool" agreement' (p136)... 'the pool and the sterling area operate by mutual agreement and understanding' (p137)

⁵⁰³ Meyer, *Britain, the sterling area*, pp92-4

⁵⁰⁴ Wright, 'Dollar pooling', Table III, p571

⁵⁰⁵ Bhagat, 'Working', pp205, 213

focusing only on drawings from the pool was incomplete analysis,⁵⁰⁶ a reasonable critique,⁵⁰⁷ and Bhagat also referenced Australia's export surplus with continental Europe, which contributed gold to the UK through the EPU arrangements.⁵⁰⁸ Perkins similarly showed that, after the 1951-2 crisis, Australia's regional pattern of payments in the 1950s was a consistent direct dollar payments deficit, combined with an even larger surplus with the non-dollar non-sterling area (NDNSA, comprising Western Europe, Japan, China etc), balanced by a large deficit with sterling area countries (principally the UK) – and a small deficit overall, reflected in the decline in reserves. Consequently, he argued that Australia was a net contributor to the sterling area's gold and currency reserves by virtue of its net surplus with the NSA⁵⁰⁹ (although it could be argued that sterling's widespread use in the NDNSA at least helped to enable this surplus). These trading trends and patterns established in the 1950s (deficits with the USA and UK, net surpluses elsewhere), continued into the 1960s.⁵¹⁰

The literature is thus not contradicted by the findings of the previous Section, in which it was seen that, at the microeconomic central bank level, Australia was a direct spender of dollars through the 1950s-60s, and only accumulated dollars through gold production/GPA gold sales (Figures 7-9 and Annex 3). Moreover, as pointed out by Zupnick, spending of sterling reserves permitted an accelerated pace of development in RSA countries like Australia, with inflationary consequences for the whole sterling area.⁵¹¹ As Copland explained, the importance of Australia's development ambitions, which necessitated dollar imports of capital goods, inevitably had domestic inflationary consequences, so that spending sterling reserves, and borrowing dollars, was a 'sensible anti-inflationary device'.⁵¹² In resisting the UK's call for widespread import

⁵⁰⁶ Kamarck, 'Pooling: comment'

⁵⁰⁷ See, for instance, Meyer, *Britain, the sterling area*, which argued that 'the United Kingdom export surplus with the R.S.A. must be regarded as a United Kingdom contribution to the Pool' (p79)

⁵⁰⁸ Bhagat, 'Working', p205

⁵⁰⁹ Perkins, *Britain and Australia*, pp139-40

⁵¹⁰ Dyster and Meredith, *Australia in the international*, p249

⁵¹¹ Zupnick, 'The sterling area's'

⁵¹² Copland, *Inflation and expansion*, p54

controls against the NSA in the 1951-2 crisis, the Australian Cabinet made clear that imports were a major plank of counter-inflationary policy.⁵¹³ Similar counter-inflationary thinking underlay the decision to end import licensing in 1960.⁵¹⁴ Under these circumstances, in the binary currency world of the 1950s, the pool also supported Australia in its exchange rate management, as Meyer argued:

‘Australia cannot change her monetary standard without great cost...independent currencies would hardly be as widely acceptable in present-day conditions. As independent currencies, most R.S.A. currencies would have a lower value than at present’⁵¹⁵

Copland argued the same in Australia’s case,⁵¹⁶ while adding that, ‘in the long run it is our relation to the dollar and to gold, and not to sterling, that matters most’. Copland was hoping that Australia could build up a separate dollar reserve, ‘so that she could eventually contract out of the sterling area dollar-pooling arrangements’,⁵¹⁷ but Perkins argued that this both became impractical (because of the scale of dollar deficits) and was uneconomic because getting there would have involved self-imposed restrictions preventing Australia from buying dollar goods at the cheapest cost (as it could via the pool), and building reserves (sterling and dollar) that were larger than necessary.⁵¹⁸

Inevitably, pooling created conflicts between the UK and Australia, particularly in the crises of 1947 and the early 1950s.⁵¹⁹ The UK Treasury was initially less concerned

⁵¹³ NAA:A4905,183,4678280, Cabinet minute, ‘Sterling Area dollar position...’, 4/12/1951

⁵¹⁴ Dyster and Meredith, *Australia in the international*, p239

⁵¹⁵ Meyer, *Britain, the sterling area*, p93

⁵¹⁶ Copland, *Inflation and expansion*, p76

⁵¹⁷ Copland, *Inflation and expansion*, p77

⁵¹⁸ Perkins, *Britain and Australia*, pp158-9

⁵¹⁹ In Sep/1947 there was a British suggestion that Australia should live within its dollar income, which the Australian government regarded as unacceptable (Lee, *Search for security*, pp34-5). One technique the Australian government used to soften British calls for reductions in dollar imports was to draw dollars from the IMF instead, as it did in 1949 and 1952. (For 1949, see Andre, *Documents*, pp90-2, 102-3. For 1952, BOE:OV13/30, ‘Note of a telephone conversation...’, 17/4/1952; Telegram, Washington to Franks, ‘Confidential – International Monetary Fund’, 26/4/1952). In 1950, it also began borrowing dollars, against the wishes of the British (Lee, *Search for security*, pp144-5)

about Australia keeping its own gold production from March 1951, but the retention of dollars from GPA gold sales, from December 1951, set a bad pooling precedent for other countries.⁵²⁰ When this was combined with the beginnings of an EPU deficit for the UK, 'brought about largely by heavy Australian spending in Europe',⁵²¹ matters came to a head in early 1952. The British tried to impose dollar rations and balance-of-payments targets on Australia and other sterling area countries. The Australian Prime Minister refused to accept these, arguing that they were against the team spirit of the sterling area.⁵²² In March 1952, to address its balance-of-payments crisis, Australia imposed general import controls, including towards sterling area goods, against the wishes of the British.⁵²³ At a London meeting in May 1952, the UK Treasury tried unsuccessfully to convince Treasury Secretary Wilson to abandon the policy of GPA gold sales for dollars, and to spend at least half the previously accumulated dollars on dollar debt redemptions over the next four years.⁵²⁴ While Wilson did make commitments to spend some of the dollar 'pot' on financing Australia's 1952 dollar deficit, and redeeming dollar maturities that could not be refinanced, his indication that the combined gold and dollar holdings would be no higher in three years' time, was, as the previous Section showed, not fulfilled.⁵²⁵ In the later 1950s and 1960s, pooling, and the minor ad hoc divergences undertaken by Australia, did not seem to create such friction, but the retention of gold production remained a British grievance,⁵²⁶ and

⁵²⁰ TNA:T267/29, 'Sterling balances', p61

⁵²¹ Grey, 'The sterling area', p133

⁵²² RBA:B.1.1.1.C.4.4, Fadden to Menzies, 21/1/1952; RBA:B.1.1.1.C.4.4, Menzies to Fadden, 21/1/1952

⁵²³ Whitwell, 'Economic policy', p174. When the Chancellor tried to persuade the Treasurer to free the controls on UK imports in 1954, citing the improvement in Australia's balance of payments, the Treasurer rebuffed the appeal, replying that it was the restriction on dollar imports that was giving Australian policymakers most concern (RBA:B.1.1.1.A.65.2, 'Secret: supplementary message...', 24/6/1954; 'Message from the Treasurer...', 22/7/54). Indeed the UK and Australia found themselves leading different factions in GATT, Australia seeking freedom to impose quantitative restrictions, the UK trying to limit them (RBA:GJP-56-1, Randall to Coombs, 8/12/1954, enclosing letter, Crawford to Wilson, 22/11/1954; 'Article XII...9th-20th November'; 'I was in Canberra yesterday...', 14/9/1954). The general import controls of 1952-60, which varied with the balance of payments, were more discriminatory against the dollar area, but only slightly so, since the US\$400m proceeds of World Bank loans, and also imports of petroleum products, were outside the controls (Crawford, *Australian trade policy*, pp490-525; RBA:C.3.7.7.14, 'How import licensing works', Department of Trade, Feb/1957)

⁵²⁴ TNA:T236/4648, Flett to Brittain and Rowan, 'The use of Australia's gold', 24/5/1952.

⁵²⁵ TNA:T236/4648, 'Australian gold', c.26-30/5/1952; Flett to Brittain, 'Australia...gold and dollar reserves', 7/6/1952. Gold and dollar holdings increased from A\$123m to A\$155m between Jun/1952 and Jun/1955

⁵²⁶ TNA:T267/29, 'Sterling balances', pp61-2

Australian officials were still well aware of British sensitivities. In considering diversification from sterling in July 1968, the RBA board paper warned: 'the U.K. would dislike switches' and suggested possible ways to meet British objections.⁵²⁷

It is clear, therefore, that sterling area membership was valued by government officials. Membership was valuable in the 1940s, because the pool gave Australia a means to buy needed dollars.⁵²⁸ This was true of the 1950s, providing access to British capital and dollars, even after Australia became a 'net contributor to the pool' through its surplus with the NDNSA.⁵²⁹ And it was true of the 1960s, both for private capital and government borrowing on the London market, as Singleton and Schenk observed.⁵³⁰ The private capital flow from the UK was especially important,⁵³¹ as illustrated by Figure 15.

⁵²⁷ RBA:BM-Pe-95, Board Memorandum, 'Australia's international reserves', Research Department, 26/7/1968

⁵²⁸ Andre, *Documents*, pp93-6; Lee, *Search for security*, p31-5; McKenzie, 'In the national interest', pp564-5; Schedvin, *In reserve*, pp115, 182

⁵²⁹ NAA:A9879,3407,1347993, 'The Sterling Area Currency Pool', Trade and Customs, Feb/1950; RBA:B.1.1.1.A.65.2, minutes of London Commonwealth Liaison Committee, 12/12/1951;

NAA:A1838,708/13/4PART2,330620, Fadden to Casey, with memorandum 'Sterling Area—contributions...', 24/2/1958; O'Donnell to Secretary, External Affairs, with 'note of conversation', 30/5/1958

⁵³⁰ RBA:BM-C-154, CBAC Memorandum, 'Australia's overseas reserves', 18/1/1962; Perkins, *Britain and Australia*, p151; Singleton and Schenk, 'The shift'

⁵³¹ TNA:T267/34, 'Exchange control 1959/1972', pp6-38; Perkins, *Britain and Australia*, pp140-1, 177-83; Whitwell, 'Economic policy', p179

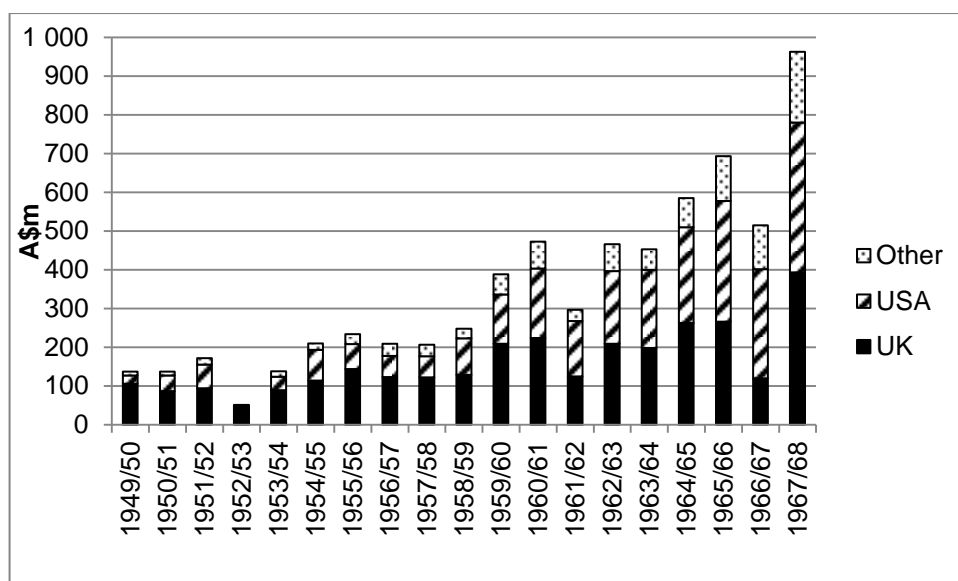


Figure 15: Capital investment in Australian enterprises – by source, annually during year ended 30 June, 1950 – 1968 (A\$m)

Source: RBA, <http://www.rba.gov.au/statistics/frequency/occ-paper-8.html>, 'Australian economic statistics 1949-1950 to 1996-1997, Occasional paper no. 8', 'Section 1: Balance of Payments', '1.17 [XLS] Inflow of foreign investment in enterprises by country' (accessed 15 Feb 2015)

What about the sterling peg? Australia had two theoretical exchange rate pegging commitments: one to gold and the dollar under the IMF rules, and the other to sterling. Being a no-margins peg for the central bank, the latter dominated, but how committed was Australia to the sterling peg in the 1950s-60s?

An indirect test of Australia's commitment to sterling pegging is to consider times when Australian officials discussed changing the exchange parities. I found in the RBA and Government archives a number of occasions when such changes were considered, and these are referenced in Table 1.

	Australian government or central bank discussions:	
A£/A\$ change:	Following UK move:	Independent move by Australia:
Rise vs US\$	1951 ⁵³² , 1954 ⁵³³	1950 ⁵³⁴ , 1951 ⁵³⁵
Decline vs US\$	1946-8 ⁵³⁶ , 1949 ⁵³⁷ , 1966 ⁵³⁸ , 1967 ⁵³⁹	1961 ⁵⁴⁰
Float vs US\$	1952 ⁵⁴¹ , 1954 ⁵⁴² , 1955 ⁵⁴³ , 1969 ⁵⁴⁴	1953 ⁵⁴⁵ , 1954 ⁵⁴⁶ , 1955 ⁵⁴⁷ , 1956 ⁵⁴⁸ , 1961 ⁵⁴⁹

Table 1: Years in which Australian officials discussed changing Australia's exchange parities, 1946 – 1969

Source: See footnotes

Note: Officials = government or central bank

The important inference that can be drawn from these debates is that, while officials favoured the status quo of pegging to sterling at its *current* rate, Australia following the UK in exchange rate *changes* was not, at any time, a foregone conclusion.

Interestingly, of these years, the only ones in which Australian officials were recommending following the UK in a mooted significant fixed rate move were 1949 and 1966 (they were non-committal in 1951). Between April and July 1949, the policy view

⁵³² NAA:A571,1949/3662,5107739, Advisory Council Memorandum, 'United Nations E.C.E. Report...', 27/6/1951

⁵³³ See footnote for 1954 float against US\$, following UK move – both questions were covered

⁵³⁴ NAA:A571,1949/3662,5107739, 'Initial effects of devaluation...', Treasury, 5/2/1950; Coombs to Watt, with draft to Fadden, 6/2/1950; 'Exchange appreciation', CBA, 6/2/1950; 'Appreciation of £A', 20/2/1950

⁵³⁵ NAA:A571,1949/3662,5107739, 'The case for...', Treasury, 2/2/1951; 'Case against appreciation', Wheeler to Fadden, 21/2/1951; Coombs to Fadden, 20/2/1951; 'What could reserve appreciation do?' (undated)

⁵³⁶ NAA:A571,1949/3662,5107739, 'Australian Exports, Notes...', 5/2/1948; Andre, *Documents*, p44; NAA:A571,1948/3178,5116120, 'Extract from Notes...', 28-29/10/1948; RBA:B.1.1.1.A.65.2, 'Extract from letter...', 16/11/1948

⁵³⁷ NAA:A571,1948/3178,5116120, McFarlane to Chifley, 18/2/1949; NAA:A571,1965/588,304528, 'Extract from notes...', Wheeler, 22/3/1949; Phillips to Randall, 12/4/1949; 'Devaluation of sterling', 7-12/4/1949; NAA:A571,1949/2670,341817, Wheeler to McFarlane, 11/4/1949; 'Devaluation of sterling...', 23/6/1949; 'Basic data for McFarlane', 30/6/1949; 'Notes on discussion...', Wright, 18/7/1949 (partly in Andre, *Documents*, pp85-6); RBA:S-a-735, Wright to Wheeler, 14/9/1949; NAA:A571,1965/324PART1,342530, McFarlane to Chifley, 19/9/1949; RBA:GJG-51-1, Draft letter, McFarlane to Watt, 19/9/1949

⁵³⁸ NAA:A571,1965/588,317686, 'Possible Australian response...', 24/8/1966; RBA:GDB-73-1, 'In the event of...', 18/11/1966

⁵³⁹ Ashton, Bridge and Ward, *Documents*, pp586-667; RBA:GDB-73-1, International Committee, 'Exchange Rate Strategy...' Oct-Nov documents, 14/11/1967; RBA:BM-C-372, BM-C-371, BM-C-370, CBAC Minutes (2-22/11/1967); Frame, *Harold Holt*, pp239-41; BOE:OV44/144, 'Devaluation: record of visit...', DWC Allen to Morse, 24/11/1967

⁵⁴⁰ RBA:IT-a-511, 'Ways of correcting...', Research Department, 15/2/1961

⁵⁴¹ NAA:A571,1952/1268,317686, Melville to Wilson, 9/5/1952; RBA:IT-a-511, Numerous departmental documents, 19/5-27/10/1952

⁵⁴² RBA:IT-a-514, Numerous departmental documents, 5/5-1/6/1954

⁵⁴³ RBA:IT-a-511, Board Memorandum, 'Banking (Foreign Exchange)...', Secretary's Department, 13/1/1955

⁵⁴⁴ RBA:GDB-70-2, 'Paragraph for Governor: flexible exchange rates', 10/9/1969

⁵⁴⁵ RBA:IT-a-511, 'Fluctuating rates', Wright and Walker, 17/11/1953

⁵⁴⁶ RBA:IT-a-511, 'Comments on memoranda...', 23/2/1954; 'Comments by J.M. Garland...', Economic Department, 26/2/1954; 'Fluctuating exchange rates', Phillips' comments, 26/2/1954; 'Fluctuating exchange rates', 2/3/1954

⁵⁴⁷ RBA:B.1.1.1.H.93, 'Australia and convertibility', Exchange Control, 18/9/1958: this cites Coombs-Wilson letter in 1955

⁵⁴⁸ NAA:A571,1952/1268,527540, 'Free exchange rates', Jan/1956; Coombs to Fadden, forwarded by Coombs to Wilson, 20/1/1956; Fleming to Bury and Woodrow, 6/2/1956; Woodrow to Fleming, 15/2/1956; Bury to Fleming, 23/2/1956

⁵⁴⁹ RBA:IT-a-511, 'A fluctuating exchange rate...', 7/3/1961

changed from not following a sterling devaluation, to depreciating by 10 per cent only, to probably following the UK completely: electoral considerations weighed heavily in the Labour government's decision to follow sterling. Between 1966 and 1967, the majority view changed from partially following a sterling devaluation, to not following it. In the 1950s, officials were prepared to follow the UK only in a limited, managed float, one which would not involve too much variation against the US dollar, and this theoretical acceptance of floating with sterling was for technical/practical reasons (see below) rather than because they liked the idea. At times of Australian weakness, an independent float or devaluation was also considered (but rejected).

There is not space to cover all the details of these referenced debates, but the consistent reasons that emerge for these views are the macroeconomic policy objectives from Section 2. Australian officials valued a stable, competitive, fixed rate of exchange against major trading partners. Devaluation was opposed because of elasticity pessimism – the concern that it would not help export volumes or reduce imports sufficiently – and fear of inflationary effects and loss of confidence effects on capital inflow. Revaluation was opposed because of its deflationary effects, the risk of income loss for manufacturers and agricultural exporters, and because of fears that a higher exchange rate would deter capital inflow. The peg question was inextricably mixed up in the attraction of the pool to Australia, as Coombs noted,⁵⁵⁰ and was also affected by the lack of an FX market for the Australian currency (see below). In the decade or so after the war, there really was no alternative to staying with the sterling area, due to the UK's exposed financial position, as Melville explained.⁵⁵¹ Perhaps all that can be said is that, because devaluation and a competitive rate were more often part of the official discussion than revaluation, sterling, being intrinsically weaker than the dollar, was a more congenial pegging candidate.

⁵⁵⁰ Coombs, *Trial balance*, p150

⁵⁵¹ Cornish, 'Sir Leslie Melville', p450

Thus far we have discussed mainly the peg and the pool, but the feedback effects on reserve management from Australia's sterling orientation went wider than these. Indeed one can isolate seven different effects, which are summarised in Table 2, and discussed in the paragraphs below. They derived both from *rules*, and from Australia's *institutional inheritance*. Sometimes the effects were the *direct* consequence of a rule, as in the case of pooling, and sometimes they operated through the usual economic mechanisms of the transactions theory, such as the way in which sterling pegging led to a need for intervention reserves. In the latter case, we are talking about *additional* institutional factors that influenced those economic mechanisms, such as the effect of liberal London trade credit on Australia's sterling trade with the NSA, the effect of the lack of an FX market in Australia on its ability to break with the sterling peg, or the effect of converting all borrowings to sterling on the traditional link between debt denomination and reserve holdings. In his political analysis of reserve currencies, Helleiner called such influences *indirect*, not to belittle them, but to distinguish them from more direct (in his case political, here institutional) mechanisms.⁵⁵²

⁵⁵² See Helleiner, 'Political determinants'. The economic transactional forces (trade, debt and anchor currency) are those already referenced (Eichengreen and Mathieson, 'Currency composition')

Source: Institutional inheritance or rule?	Name of effect	Description and comment
Both	Sterling peg: anchor effect	Under pegging rule, Australia should peg to sterling. The peg necessitates reserves for intervention, automatic due to mobilisation. But also the inherited lack of a foreign exchange market in Australia makes it hard to break from sterling peg
Rule	Pooling rule	All balance-of-payments proceeds should be converted into sterling reserves. Due to rules about consultation, breaches of pooling rule easily observed by UK
Rules (peg and pool)	Minimum buffer	Precautionary demand for minimum sterling buffer given balance-of-payments volatility
Legal inheritance	Note issue	Demand for sterling assets in the note issue fund (US dollars were not eligible, and there were some practical constraints regarding holdings of gold and Australian domestic assets)
UK rule	Capital flight from UK	Supply of sterling increases due to uncontrolled capital flight from UK at times of sterling crisis
Both	Currency of trade	Sterling share of payments nearly three times greater than UK trade share in early 1960s. This is due to exchange control rules (making sterling dominant in intra-sterling area trade) and liberal supply of sterling trade credit from London (for trade with non-sterling area)
Rule	Pooling rule: debt	Under pooling rule, all debt proceeds converted to sterling, and all debt payments and redemptions funded from sterling. Hence source of debt has less transactional influence on demand for reserves

Table 2: Effects of sterling orientation on Australia's reserve management, 1950 – 1968

Source: Author's assessment (see argument)

5.1 Sterling peg, and the lack of a foreign exchange market in Australia

As we have discussed, the economic literature ascribes a leading role to anchor currency in determining reserve choice. Australian pegging to sterling had preceded the formal sterling area, in the 1930s, but there was no country during the 1950s-60s which pegged to sterling which was not a member of the sterling area. Pegging to sterling did not necessarily imply large sterling reserves: South Africa pegged its currency to sterling from January 1933⁵⁵³ to August 1971,⁵⁵⁴ but did not hold significant sterling reserves (see Annex 2). Pegging to sterling was a rule of the sterling area. This is an obvious point. But less obvious was the lack of an FX market in Australia, which made it hard for the Australian authorities to end the sterling peg.

⁵⁵³ South African Reserve Bank, 1921-1971, p39

⁵⁵⁴ De Vries, *International Monetary Fund*, 1966-1971, p542

As already mentioned, in Australia, international trading banks dealt in sterling as agents of the RBA at a fixed price and settled up by surrendering sterling to the RBA every month. Theoretically, the RBA's close control over all FX transactions through its agent banks had advantages: it could protect monetary policy from speculative behaviour. But it was the central bank, not the trading banks, which tried to open up the system in the 1950s. Given trade volatility and widespread use of forward settlement, trading banks did not welcome the exchange risk of dealing on their own account. When in 1954 the CBA tried to introduce 'at risk' dealing margins around a sterling parity, as was practised in the UK, the trading banks prevented the move.⁵⁵⁵ When the possibility of floating the Australian pound was debated in 1956 and 1961 within the central bank, the difficulty of changing mobilisation and exchange control procedures and the transition for trading banks were raised as objections.⁵⁵⁶ As late as 1969, the RBA's International Committee was divided on how soon to break with sterling if sterling floated. 'Some preferred to retain our link until an adequate foreign exchange market was established'.⁵⁵⁷ The preparatory work for such a change was a joint RBA-Bank of England study in 1969, aimed at the creation of an FX market in Australia.⁵⁵⁸

5.2 The pooling rule

As Section 4 showed, Australia was largely following the sterling area's pooling rule throughout the period. This was acknowledged by officials, even in the mid-1960s.⁵⁵⁹

⁵⁵⁵ RBA:IT-a-511, Board Memorandum, 'Banking (Foreign Exchange)...', Secretary's Department, 13/1/1955

⁵⁵⁶ NAA:A571,1952/1268,527540, Coombs to Fadden, forwarded by Coombs to Wilson, 20/1/1956; RBA:IT-a-511, 'A fluctuating exchange rate...', 7/3/1961

⁵⁵⁷ RBA:GDB-70-2, 'Paragraph for Governor...', 10/9/1969

⁵⁵⁸ BOE:C43/559, 'Joint study and report...', 3/1/1969

⁵⁵⁹ Thus in 1965 the RBA's head of investments could only look forward to the time when, 'with changing international relationships', the run-up and run-down of reserves might also be in dollars as well as in sterling (RBA:GHK-65-1, 'Talking points: handling...', 25/11/1965). As another example, RBA officials in 1962 noted that Japan's new dollar purchasing of wool was increasing the supply of dollars, creating an opportunity for diversification. But the proceeds were all being converted into sterling according to the pooling rule, and this policy did not change (RBA:BM-C-154, CBAC Memorandum, 'Australia's overseas reserves', 18/1/1962; RBA:BM-C-172, CBAC Meeting, 'Foreign exchange operations', 19/7/1962)

Robertson and Singleton were thus mistaken, but not alone, when they referred to 'the termination of dollar pooling in 1958'.⁵⁶⁰ The pool did not end in 1958. The technical changes accompanying sterling convertibility had little direct impact on sterling area countries.⁵⁶¹ Of course, this rule could be breached through diversifying, and from 1962, Australia did so to a limited degree. But breaking rules risked political conflict which might affect the capital flow that Australia valued so highly. As we have seen, Australian officials often consulted the UK on reserve management policies. The UK kept a close watch on Australian reserve movements.⁵⁶² The RBA's London office had an intimate relationship with the Bank of England's Dealing and Accounts Office.⁵⁶³ This was necessary, as the RBA had a privileged independent dealing status in the London market relative to other sterling area central banks,⁵⁶⁴ and it was expected to co-operate with the Bank e.g. by supporting UK Treasury bills and consulting in gold and FX dealings.⁵⁶⁵

5.3 Minimum buffer

Given the pooling rule and transactional use of sterling, it was the 'London funds' of the RBA's Central Banking Business that bore the brunt of Australia's balance-of-payments movements. The need for minimum holdings of currencies required for

⁵⁶⁰ Robertson and Singleton, 'The Commonwealth', p260

⁵⁶¹ The CBA's post-convertibility exchange control instructions in 1959 confirmed that all NSA currencies would continue to be sourced from the sterling area pool (RBA:B.1.1.1.H.9.3, 'Exchange Control, Sterling convertibility...', To all Australian capitals, 17/1/1959)

⁵⁶² BOE:OV13/43, 'Reserve Bank of Australia – weekly returns', Overseas Office, Group IIIA for DWC Allen, 29/1/1960; BOE:EID3/98-106, 'Monthly report on external finance...'; BOE:EID10/1-10, EID1A129/2-4, 'Monthly report on overseas financial...'

⁵⁶³ RBA:C.3.15.7.34, '...Visits to Bank of England, 25th-29th September, 1961', Wright, 14/11/1961. Sometimes the RBA's London officers even passed Sydney's negotiating instructions to their opposite numbers at the BOE, since the instructions are in the BOE's files (for example, BOE:C43/267, 'Cable from the Governor received on 31/8/56...', 'Urgent and confidential'; and various notes in BOE:C40/174)

⁵⁶⁴ BOE:OV13/43, 'Reserve Bank of Australia – weekly returns', Overseas Office, Group IIIA, for DWC Allen, 29/1/1960; RBA:IT-h-351, Rusden to Bryson, 10/9/1953: 'the question of our right to operate in this money market will be forever delicately poised: I can assure you this issue is real!' The privilege agreement dated back to the earlier noted BOE-RBA correspondence of Jun/1934)

⁵⁶⁵ For evidence of co-operation in Treasury bills, see BOE:C44/41, Memorandum to Chief Cashier, 'Commonwealth Bank of Australia', 27/5/1957, and addendum, 11/6/1957; for gold sales, see a 14-day best execution order taken in Nov/1960, BOE:C43/559, Chief Cashier to RBA London manager, 4/11/1960; for FX dealings, see BOE:C43/559, RBA London to Chief Cashier, 'International Monetary Fund drawing...', 27/4/1961; Cable from Governor, 16/3/1962 (RBA internal); Cable to Governor, 16/3/1962 (RBA internal); for an expression of gratitude, see BOE:OV13/43, Coombs to Cobbold, 15/5/1961

intervention (particularly from a currency peg, here arising from the combination of pegging and pooling) is well-known in central bank reserve management. But it is not something that has been acknowledged or analysed in the writings about Australia's reserve management in this period, save for Schenk's aforementioned citation of Menzies about a £200m minimum, or Perkins' guess of a £100-200m minimum. For most of the period, officials regarded approximately £100m (= A\$250m) as the minimum safe level for London funds. This emerges both from internal RBA papers about minimum reserves between 1952 and 1968, and through evidenced actions taken in episodes when this minimum was tested, in 1952, 1956 and 1961. It is noteworthy that, by November 1967, London funds had already decreased to less than the £100m level.⁵⁶⁶

The findings from the relevant RBA papers are given in Table 3. The 1957 and 1968 papers updated certain conclusions from the original September 1952 memorandum, which argued that the Central Banking Business needed to set a minimum level of reserves because of the risk of running out of money due to capital and trade flows outside the central bank's control. The 1965 paper was used to justify an extension of the maturity of the A\$300m of sterling holdings deemed 'hard core'. It is clear from the papers that officials saw sterling as the transactional currency and wanted to hold gold and dollars for their own sake and for window-dressing rather than for use.⁵⁶⁷

⁵⁶⁶ Since total sterling reserves were then less than £300m and the note issue accounted for two-thirds of this (RBA:BM-Pe-94, Board Memorandum, 'Distribution of estimated profits...', Attachments)

⁵⁶⁷ For example, the 1965 paper argued that then non-sterling holdings should not be reduced at all (RBA:BM-Pe-56, Board Memorandum, 'Investment of overseas funds', Attachment, Investment Department, 21/1/1965)

A\$m	'Minimum'			'Adequate' ⁵⁶⁸	Actual (end-June)	Source
	Stg	Non-stg	Total			
1952	200 ⁵⁶⁹	60	260	1,000	700	CBA paper ⁵⁷⁰
1957	N/A	N/A	N/A	1,200 ⁵⁷¹	1,021	CBA paper ⁵⁷²
1965	300	300	600	N/A	1,292	RBA paper ⁵⁷³
1968	N/A	N/A	450	1,500	1,028	RBA paper ⁵⁷⁴

Table 3: Australian policymaker estimates for 'minimum' and 'adequate' reserves, 1952 – 1968 (A\$m)

Source: For actual reserves, see Figure 3; for 'minimum' and 'adequate' estimates, see footnotes

Secondly, there was practical evidence for a minimum of £100m London funds. In 1952, 1956 and 1961, the London funds declined to £100m⁵⁷⁵ and would have fallen substantially further had it not been for mitigating action. In 1952 there was a transfer of sterling from the NID, followed later by an IMF drawing.⁵⁷⁶ The action in 1956 and 1961 included further such transfers, gold and dollar sales for sterling, conversion of new loans to sterling and in 1961 a large drawing from the IMF (A\$156m), all converted into sterling.⁵⁷⁷ Figure 16 shows the monthly level of London funds between 1953 and 1962.

⁵⁶⁸ The 'adequate' measure is not directly relevant to the 'minimum' but it does provide an indication of the increasing requirements over time arising from imports and FX outgoings. 'Adequate' was interpreted in the 1950s as the level which reserves would need to reach before import controls could be *temporarily* removed. The use of 'minimum' and 'adequate' shows that the RBA was implicitly taking a 'buffer stock' approach to reserves – see Flood et al, 'Holding international reserves'; Frenkel and Jovanovic, 'Optimal international reserves'

⁵⁶⁹ This is lower than A\$250m. The recommendation of the CBA's London manager had been that £125-150m (= A\$313-375m) was the 'minimum comfortable level to which we should permit cash and short-call in London to fall'. However, the paper's author in Sydney had significantly discounted that estimate on the grounds that policy and controls could be tightened as the minimum level was approached (RBA:GDB-73-1, Board Memorandum, 'Minimum level of international reserves', Economic Department, 19/9/1952). In summary, the Sydney officer believed London funds could be allowed to fall below £100m, while the London manager strongly favoured minimum London funds of greater than £100m

⁵⁷⁰ RBA:GDB-73-1, Board Memorandum, 'Minimum level of international reserves', Economic Department, 19/9/1952

⁵⁷¹ In 1957, *permanent* removal of import controls would have required A\$1,600m of reserves, according to the RBA paper

⁵⁷² RBA:C.3.7.7.19, 'The level of international reserves', Economic Department, 9/2/1957

⁵⁷³ RBA:BM-Pe-56, Board Memorandum, 'Investment of overseas funds', Attachment, Investment Department, 21/1/1965

⁵⁷⁴ RBA:GDB-73-1, CBAC Memorandum, 'Possible action to protect...', International Committee, 9/2/1968

⁵⁷⁵ For 1952, RBA:IT-h-351, extract from Bryson-Rusden letter, 3/6/1952. The funds reached £100m in Feb/1952. A Feb/1952 document also talked of the need for 'conservation of sterling funds' in light of 'the uncertainty of our London position' (RBA:B.1.1.1.C.3.2, 'Capital transfers', Exchange Control, 22/2/1952). For 1956 and 1961, Figure 16

⁵⁷⁶ £30m (RBA:IT-h-351, extract from Bryson-Rusden letter, 3/6/1952). £55m of gilts were sold in Mar-Apr/1952 in order to liquefy the sterling holdings (BOE:C40/174, 'Commonwealth Bank – sales...', 2/5/1952). Australia also drew US\$30m from the IMF in Aug/1952, but the drawing had been negotiated in March and approved in April (BOE:OV13/30, 'Note of a telephone conversation...', 17/4/1952; Washington to Franks, 'Confidential – International Monetary Fund...', 26/4/1952; TNA:T236/4648, 'The use of Australia's gold...', Flett to Brittain and Rowan, 24/5/1952)

⁵⁷⁷ RBA:GJP-57-1, Bryson-Rusden letter, with attachment 'Overseas Assets', 9/2/1956; RBA:S-L-236, 'Monthly review', Jan-Mar/1961; RBA:BM-Pe-1 to -23 and -26, Board Memoranda, 'Investment of

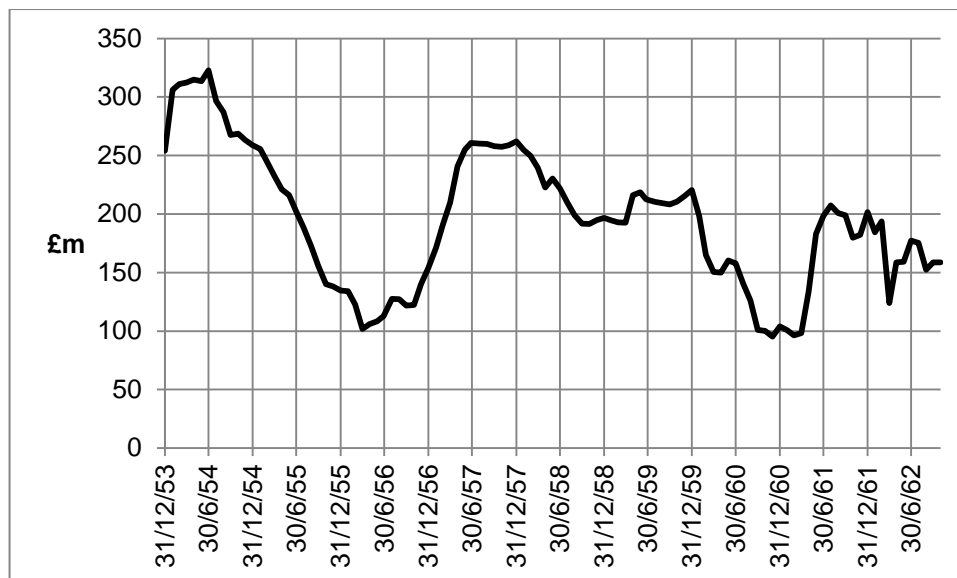


Figure 16: Australian central bank total London funds recorded in monthly reports from London office, at end-month, December 1953 to October 1962 (£m)

Source: RBA:C.3.20.1.19-1,C.3.20.1.19-2,C.3.20.1.20-1,C.3.20.1.20-2,S-L-232,S-L-233,S-L-236,S-L-237,S-L-238,S-L-239, 'Monthly Review'

The minimum figure of around £100m for London funds is also supported by consideration of its components. In March 1961, the London office's money at call was around £25m, UK Treasury bills £57m, British government securities £15m and Australian government sterling securities less than £1m, giving a total of £98m.⁵⁷⁸ The guidance from Sydney was that money at call should not fall below £20m.⁵⁷⁹ There was a broad rule of thumb that UK Treasury bills should be around twice money at call when funds were tight, and the Bank of England had also suggested that a minimum figure of £40-60m should be kept in UK Treasury bills in the London funds.⁵⁸⁰ Finally British government securities were usually allowed to run to maturity and it was expensive to sell them.

overseas funds', Jan/1960-Jan/1962 and Apr/1962. As discussed in Section 4 and shown in Annex 3, the board papers reveal that, in the 1960-1 crisis, the RBA even began spending dollar capital reserves on current dollar purchases

⁵⁷⁸ RBA:S-L-236, 'Monthly Review', Mar/1961

⁵⁷⁹ RBA:GJP-57-1, Phillips to Hawley, 8/2/1957

⁵⁸⁰ RBA:IT-h-351, Rusden to Bryson, 10/9/1953

5.4 Note issue

As explained earlier, the RBA's reserves were divided between the Central Banking Business and the Note Issue Department (NID). From 1945, the NID had freedom to hold all its assets in Australian securities,⁵⁸¹ but in practice the central bank's policy was to hold a large proportion of the fund in external assets.⁵⁸² In this respect, the fund had an inherited bias supporting the holding of sterling reserves relative to dollars, since, by law, US dollar assets were not authorised investments for the NID.⁵⁸³ The unequal treatment of sterling and dollars caused a major shift in March 1960 when a new asset composition policy, the aforementioned Uniform Proportionate Distribution (UPD), was adopted. The new policy was that the asset category proportions of the NID should match those of the Central Banking Business. Since so much of the Central Banking Business assets was invested in 'overseas money markets' (sterling and dollars), the NID was forced to hold an equal proportion of its assets in UK Treasury bills (the only overseas money market asset permitted to it), necessitating a large internal transfer of UK Treasury bills. The new policy increased sterling's share of the NID from 32 per cent to 46 per cent.⁵⁸⁴

The note issue's share of sterling holdings increased over time. Between June 1951 and June 1967, the note issue increased from A\$550m to A\$930m.⁵⁸⁵ In December 1955, the Central Banking Business held about two-thirds of the central bank's sterling,

⁵⁸¹ Schedvin, *In reserve*, p66. Before 1945, according to Schedvin, at least 25% of the note issue had to be held in the form of gold and sterling. When the note issue was originally legislated in 1910, there were strict requirements for gold holdings against the note issue, along the lines of the BOE's own rules, as well as provision for sterling holdings. I am grateful to Selwyn Cornish for explaining to me the original 1910 statutory background

⁵⁸² See Annex 6 and also RBA:BM-Pe-3, Board Memorandum, 'Distribution of assets...', Mar/1960. The latter referred to a prior 1957 policy dividing asset increases in the note issue as to 20% in gold and balances abroad, 40% in Commonwealth Treasury bills and debentures, and 40% in other Commonwealth government securities. But this policy was disrupted by recent 'consistent selling' by the RBA of Australian government bonds, 'in line with our open market policy and associated with our portfolio problems' which had required withdrawing such bonds from the fund and replacing them with gold, UK Treasury bills and Australian Treasury bills. Hence the need for a new distribution policy in 1960

⁵⁸³ RBA:BM-Pe-3, Board Memorandum, 'Distribution of assets...', Mar/1960

⁵⁸⁴ RBA:BM-Pe-3, Board Memorandum, 'Distribution of assets...', Mar/1960

⁵⁸⁵ RBA:BM-Pe-6, Draft Annual Report, 'Note Issue Department', Jun/1960; RBA:BM-Pe-94, Draft Annual Report, '...Note issue', Jul/1968

while the NID held about one-third. By November 1967, the NID held about two-thirds of the RBA's sterling reserves and the Central Banking Business one-third.⁵⁸⁶ At the latter date, sterling still constituted around half of the assets in the NID.⁵⁸⁷

As we have seen, there were occasional flows of sterling between the Central Banking Business and the NID, and it would be useful to clarify how this division of reserves between the two departments worked. Unfortunately, apart from occasional crisis transfers of sterling from the NID to support the London funds in 1952-60, which are described variously in this paper and which suggest management autonomy and freedom to transfer assets, and the March 1960 board memorandum accompanying the UPD policy (which is discussed here and in Annex 6), I did not, while in Australia, find documents which can enlighten us on these mechanisms. The balance sheets of the two funds were published annually, but the categories of assets – e.g. 'gold and balances abroad', 'other overseas securities' – do not permit analysis of the sterling holdings. Annex 6 shows the two balance sheets over time, divided into principal categories of assets, and provides circumstantial evidence that the UPD policy continued to be followed after 1960.

It is important to clarify that the increasing concentration of sterling holdings in the NID arose because of the combination of the growth in the note issue and the UPD policy, together with the single relevant 'institutional inheritance' aspect, that US dollar investments were *not eligible assets* for the NID. Annex 6 explains how the combination of policies and circumstances *might* technically have constrained an RBA determined to minimise sterling exposures. However, the 1945 legislation was clearly

⁵⁸⁶ For Dec/1955, RBA:GJP-57-1, Bryson-Rusden letter, with attachment 'Overseas Assets', 9/2/1956; data extracted from tables in attachment and converted from A£ to A\$. For Nov/1967, RBA:BM-Pe-94, Board Memorandum, 'Distribution of estimated profits...', with attachments, 3/7/1968

⁵⁸⁷ This figure is estimated by comparing two-thirds of the RBA's sterling reserves in that month (£187m out of £280m, the latter figure extracted from RBA:BM-Pe-94, Board Memorandum, 'Distribution of estimated profits...', with attachments, 3/7/1968) against the value of the note issue fund interpolated from the RBA's Annual Reports (the Jun/1967 figure being A\$930m = £372m)

aimed at removing note issue constraints.⁵⁸⁸ So we do not know enough to make strong claims in this respect.

Perhaps the more interesting question is why the UPD was adopted. The March 1960 board paper seemed to suggest that the UPD addressed the different profit distributions of the NID (all to government) and the Central Banking Business (partly to central bank reserves and partly to government).⁵⁸⁹ The dispute over the profits and losses arising from the 1961 IMF drawing, and their resolution through the UPD, also indicated the importance of the profit distribution question. On the one hand, the UPD was a simple mechanism acceptable to Treasury that seemed to resolve profit dispute between the RBA and Treasury. But on the other hand, because of the no-dollar rules of the note issue, the UPD was not in fact proportionate: it had the subtle effect of skewing sterling holdings into the NID. This diversion of sterling to the government's account might have suited a central bank concerned about the risk of losses from sterling holdings.⁵⁹⁰

In summary, there is not enough evidence about the NID and monetary policies to determine precisely how much the NID 'needed' to hold this high sterling share.⁵⁹¹ In practice, though, it seems clear that Australia's total sterling (the London funds plus the sterling in the NID) was not allowed to fall below £200m (= A\$500m) without external mitigating action. The lows for Australia's sterling holdings reached in September 1952 and March 1961 were around £200m, and the low in 1956 only a little below this figure and rapidly rectified.⁵⁹² These findings support and justify the citation, highlighted by Schenk, about £200m being a minimum sterling reserves figure for Australia in the

⁵⁸⁸ See Annex 6

⁵⁸⁹ RBA:BM-Pe-3, Board Memorandum, 'Distribution of assets...', Mar/1960

⁵⁹⁰ RBA:BM-Pe-94, Board Memorandum, 'Distribution of estimated profits...', with attachments, 3/7/1968

⁵⁹¹ Although the separate NID was only abolished in 1989 with the deletion of Section 33 of the Reserve Bank Act, this was something that the RBA had pressed the Treasury for several times in 1967, and, according to people at the RBA, it seems that for some years prior to the 1989 abolition, all the RBA's external assets were considered holistically. I am grateful to Selwyn Cornish for this information

⁵⁹² See Table 5

1950s. By September 1968, sterling holdings were again down to £237m,⁵⁹³ suggesting pressure against minimum requirements given the growth in the note issue. But by then the MSP agreements were ushering in a new contract with the UK.

5.5 Capital flight from UK

The combined minimum buffer and note issue effects increased Australia's demand for sterling. Free capital movement from the UK to Australia,⁵⁹⁴ at times of sterling crisis, increased the supply of sterling to the RBA. The flows are hard to quantify but the increased amount of private capital flow from the UK in the year to June 1968 (A\$393m)⁵⁹⁵ suggests their importance.

Capital flight from the UK at times of crisis had long been a feature of the UK-Australia relationship e.g. between 1947 and 1951, when Australia's reserves increased from A\$400m to A\$1,600m.⁵⁹⁶ In April-May 1966, speculation about the pending imposition of UK capital controls led to a surge of anticipatory UK investment into Australia.⁵⁹⁷ The UK's subsequent 1966 'Voluntary Programme' limited FDI flows,⁵⁹⁸ but in late 1967 and early 1968, there was a wave of portfolio investment from the UK to Australia, with the RBA's research department expressing concern about the scale of the January 1968 figure.⁵⁹⁹

⁵⁹³ From £280m at the time of devaluation (RBA:BM-Pe-50 to -90, Board Memorandum, 'Overseas Funds')

⁵⁹⁴ Freedom of capital movement from the UK was the essence of the sterling area contract, reflecting the UK's Exchange Control Act 1947 and its exemption for 'scheduled territories' (sterling area members)

⁵⁹⁵ See Figure 15

⁵⁹⁶ Pre-1950 reserve figures are taken from NAA:A571,1944/1660PART8,5116536, 'Sterling balances', 'Appendix D', 28/6/1950. 1950-68 reserve figures are in Figure 3. For the speculative capital inflow of this period, see Copland and Barback, *The conflict*, pp360-91

⁵⁹⁷ NAA:A1838,792/1/6,247231, cutting from *Australian Financial Review*, 'Surge of UK capital yet to make full impact', 5/5/1966

⁵⁹⁸ See Figure 15

⁵⁹⁹ RBA:GDB-73-1, '...Capital inflow', Research Department, 29/2/1968

5.6 Currency of trade

Sterling area membership had a big impact on Australia's immersion in sterling trade. Singleton and Schenk noted the low UK share of Australia's trade (c. 25 per cent in the early 1960s). Sterling's share of payments was nearly three times higher, according to new evidence from this study. The RBA files reveal that sterling's share of Australian payments declined from 85 per cent in 1953-4 to 70 per cent in 1963-4.⁶⁰⁰

Why was sterling's share of Australian payments so high relative to the UK's share of Australian trade? There were two reasons, one hard and one soft. The hard element was the exchange control rule applying to all intra-sterling area trade: all such trade had to be settled in sterling area currencies, among which sterling was usually the obvious choice.⁶⁰¹ The soft factor was the liberal availability of sterling credit from London to support Australia's trade with countries outside the sterling area.⁶⁰² Although Japan bought wool from Australia with dollars after 1960,⁶⁰³ sterling credit supported many of Australia's export markets throughout the 1960s.⁶⁰⁴

Australia's immersion in sterling transactions – a transactional effect – therefore arose not just in the obvious sense from reserve pooling, but from the wider workings of the sterling area. This can be seen by considering the trade settlement of private agents in the 1950s and 1960s. Table 4 shows the trade settlement currency choices available

⁶⁰⁰ RBA:BM-Pe-56, Board Memorandum attachment, 'Investment of overseas funds', Investment Department, 21/1/1965. For comparison, Schenk estimated that the sterling share of New Zealand's trade was around two-thirds in 1968 (Schenk, *The decline*, pp208-9). Increasing use of Australian dollars in trade (*idem*, p209) might have further reduced the sterling share for Australia by 1968. For sterling's share generally, see *idem*, pp207-12

⁶⁰¹ TNA:T295/792, Hay to Thorpe, with draft, 'The use of sterling...', 7/5/1970. The citation adds that all sterling area trade with the UK was required to be in sterling. The rules were taken seriously by Australia (RBA:B.1.1.1.M.187, 'Hong Kong, Settlements...', Exchange Control, 29/6/1967)

⁶⁰² Schenk, *The decline*, pp212-24

⁶⁰³ RBA:BM-C-154, CBAC Memorandum, 'Australia's overseas reserves', 18/1/1962; RBA:BM-C-172, CBAC Memorandum, 'Foreign exchange operations', 19/7/1962

⁶⁰⁴ e.g. in 1966, the Australian Wheat Board expressed concern about its sales exposure to sterling. This exposure then amounted to around A\$140m, and in particular sales to China, India and [South] Korea (of these countries, India was the only sterling area member) were on longer than normal credit terms (RBA:BM-C-334, CBAC Memorandum, 'Forward exchange, Commodity Marketing Boards', Banking Department, 13/9/1966)

to one agent in a possible location (column) with a second agent in a possible location (row). It is assumed that the two agents are in different countries.

Permitted currency of trade settlement	Agent 2 location:		
Agent 1 location:	UK	RSA	NSA
UK	X	Sterling only	Indeterminate. Sterling finance available from London
RSA	Sterling only	Sterling area currency only (likely to be sterling)	Indeterminate. Sterling finance available from London
NSA	Indeterminate. Sterling finance available from London	Indeterminate. Sterling finance available from London	Indeterminate. Sterling finance available from London except in period 1957-63 and after Oct 1968 ⁶⁰⁵

Table 4: Trade settlement currencies available to agents in two locations, 1945 – 1972

Source: See evidence and argument in this Section

Note: RSA = Rest of the sterling area ; NSA = Non-sterling area

Table 4 shows that trading within the sterling area was constrained by the exchange control rules of each member, ensuring that sterling formed 90-100 per cent of the trade settlement within the area.⁶⁰⁶ Moreover, trade with the NSA was affected by the availability of sterling trade finance from London. That this sterling finance was readily available (except temporarily in intra-NSA trade as indicated in the bottom right hand box) is evidenced by Bank of England figures suggesting that sterling still accounted for 70 per cent of trade between sterling area and NSA countries in 1964, declining to around 60 per cent by 1967.⁶⁰⁷ The UK's willingness to allow sterling trade finance on such a scale in a period of exchange controls, despite frequent sterling crises, was ultimately a political decision.⁶⁰⁸ Schenk argued that sterling trade finance was contested ground between the UK government and central bank during the 1950s and 1960s. However, the zone of conflict only related to the issue of sterling finance for

⁶⁰⁵ Schenk, *The decline*, pp216-8

⁶⁰⁶ Schenk, *The decline*, p209

⁶⁰⁷ Cited in Schenk, *The decline*, p209

⁶⁰⁸ This has precedents. Eichengreen and Flandreau showed that political support, both by the Federal Reserve and the BOE, played a major part in the development of the dollar and sterling markets for bankers' acceptances in the inter-war period (Eichengreen and Flandreau, 'The Federal Reserve')

third party trade between NSA countries (the bottom right hand box). There was no attempt to control trade finance between sterling area and NSA countries until 1970.⁶⁰⁹

5.7 Pooling rule: debt

In line with the pooling rule, it was Australia's normal practice to convert the proceeds of all foreign currency loans to sterling, and to use its sterling to buy the currencies required for loan service and redemption.⁶¹⁰ Although foreign currency debt other than sterling left Australia exposed to loss in the event of a sterling devaluation, this was a confidence rationale for diversification, not a transactions argument. Pooling practice logically should have weakened the debt denomination influence on reserve currency choice.

Singleton and Schenk argued that foreign currency debt proceeds automatically diversified Australia's reserves, but the evidence does not support this claim. The board reserves series show that borrowings in Deutschmarks and Swiss francs and other currencies in the 1950s-60s did not lead to accumulation of those currencies, because they were converted into sterling. True, the government and central bank made a policy choice in May 1962 to begin retaining, temporarily, the proceeds of New York loans in dollars, but as we saw in Section 4, the net effect on reserves was small. The RBA reviewed the cumulative effect of all its diversification measures between June 1964 and June 1967. The cumulative addition to non-sterling reserves from all 'retention of loan proceeds' was a mere A\$6m.⁶¹¹

These seven effects of sterling area membership on Australia's reserve management were of varying importance, and they are obviously hard to quantify. Together, they

⁶⁰⁹ Schenk, *The decline*, p223

⁶¹⁰ There were some exceptions (TNA:T267/29, 'Sterling balances', p60-1)

⁶¹¹ Data extracted from RBA:BM-Pe-87, Board Memorandum, 'Overseas funds', 'Appendix... international reserves', Nov/1967

were substantial. Arguably the most important effects were the combination of the pooling rule, intermixed with sterling pegging, and the need for minimum sterling holdings (of at least £200m), because, in tandem, they directly affected Australia's ability to diversify, as the next Section shows. Australia's immersion in sterling transactions was also greater than the literature has appreciated.

Section 6: Explaining Australia's diversification policy over the 1950s-60s

The last Section developed Schenk's early institutional themes and observations about minimum sterling reserves in the 1950s into a full review of the effects of sterling area membership on Australian reserve management. This Section uses those insights and archival evidence, firstly, to explain the when, why and how of Australia's diversification policy over the 1950-68 years. Secondly, it integrates this explanation with the recent arguments of Singleton and Schenk.

Australia's diversification can be divided into three time periods. For the first period to 1962, apart from the retention of new gold production, it seems that Australia followed the pooling rules of the sterling area faithfully. This was acknowledged by an Australian Treasury officer in February 1962, when proposing a change in the policy. He stated that Australia had not, 'as far as we are aware, ever made a deliberate purchase of non-sterling currencies with sterling to put them in the United States or elsewhere'.⁶¹²

As Figure 6 showed, Australia went further than this, and purchased significant additional amounts of sterling, spending gold and dollar reserves between 1952 and 1961. However, the sterling was not bought out of loyalty or to meet the requirements of the UK or the sterling area, and the dollars and gold spent were certainly not 'gifts', as Robertson called these transfers, or 'protective' towards the UK, as the 1956 gold sale motivation was described by Kirshner.⁶¹³ These were purchases arising from Australia's orientation towards sterling, the volatility of its balance of payments, the pegging and pooling rules and its need for minimum sterling holdings. This is readily verified by examining each of these gold and dollar sales, see Table 5.

⁶¹² NAA:A571,1961/1966PART2, 'Distribution of international reserves' and 'Attachment: past policy...', appended to Daniel-O'Donnell note, 'Financial implications...', 28/2/1962

⁶¹³ Robertson, 'The decline?', p113; Kirshner, *Currency and coercion*, pp67,109

Month	Sale	A\$m	Commentary
Sep 1952	US\$	18	1952 crisis, lowest month for sterling reserves (below £200m) ⁶¹⁴
Apr 1956	US\$	14	1956 crisis, London funds around £100m ⁶¹⁵
Sep 1956	Gold	50	1956 crisis, lowest year for sterling reserves (below £200m) ⁶¹⁶
Feb 1959	Gold	6	Anticipating sterling run-down in 1959 ⁶¹⁷
Nov 1960	Gold	10	1960-1 crisis, London funds below £100m ⁶¹⁸

Table 5: Australian sales of gold and US dollars for sterling, 1952 – 1968 (A\$m)

Source: See footnotes to Table

Note: All sales were made through the Bank of England

Table 5 shows that all the sales of gold and US dollars were associated either with sterling holdings at their lows or anticipated to be run down, and the archival evidence noted indicates that restoration of sterling holdings was the deliberate aim in each case. Sometimes the sales were dressed up to look like loyalty. In the September 1956 gold sale, referenced in the literature about the Suez crisis,⁶¹⁹ Australian officials skilfully used their personal contacts with UK counterparts to plant the idea that the British Chancellor should ask Australia for gold as an act of support.⁶²⁰ But close

⁶¹⁴ For this episode, see NAA:AA1967/392/1BOX6, Board Memorandum, 'Dollars... premium gold sales', Secretary's Department, 22/9/1952; BOE:OV13/15, 'Australia', 3/11/1952; BOE:OV13/31, 'Australia', Hall, 15/9/1955; TNA:T267/29, 'Sterling balances', p61; TNA:T236/4648, 'Message from...Fadden', 22/9/1952; '...Fadden's message', Flett to Brittain, 24/9/1952; Flett to Snelling, 27/9/1952

⁶¹⁵ For this episode, see RBA:GJP-57-1, Rusden to Phillips, 18/5/1956; RBA:C.3.20.1.20-1, 'Monthly review...', 'Central bank: movement of funds', 9/5/1956; BOE:OV13/18, 'Gold – Australian borrowing...', Haslam to Jenkins, 1/8/1956 (Symons gave a similar description, TNA:T267/29, 'Sterling balances', p61); RBA:BM-Pe-87, Board Memorandum, 'Overseas funds...Suggested points...', Investment Department, 6/11/1967. As confirmation of these numbers, note that the sum of the Sep/1952 and Apr/1956 dollar sales, US\$35m, equates to a figure of A£16m mentioned as having been sold out of US investments in the 1950s according to a 1962 Australian Treasury document, NAA:A571,1961/1966PART2, 'Distribution of international reserves' and 'Attachment: past policy...', appended to Daniel-O'Donnell note, 'Financial implications...', 28/2/1962

⁶¹⁶ The purchase, just over £20m of gold from Perth No.1 Account, on 20/9/1956, is recorded in the BOE's gold ledgers (BOE:2A141/10). For Australian thinking behind the gold sale, see RBA:GJP-57-1, Bryson-Rusden letter, with attachment 'Overseas Assets', 9/2/1956; RBA:GJP-57-1, Rusden to Phillips, 18/5/1956. See Figure 3 for sterling reserves at end-Jun/1956 (A\$435m = £174m). See Annex 7

⁶¹⁷ An A\$200m run-down of sterling in 1959 was anticipated. See RBA:GJP-74-1, Phillips-Eyers correspondence, 9/12/1958-25/3/1959. There is a purchase of just under £2.5m of gold from Perth No.1 account on 2/2/1959 in the BOE's gold ledgers (BOE:2A141/10)

⁶¹⁸ See Section 4 and Annex 3. For the background and other measures to support sterling, see Cornish, *The evolution*, pp54-5; Figure 16 and its sources, especially RBA:S-L-236, 'Monthly review', Jan-Mar/1961; RBA:BM-Pe-1 to -23 and -26, Board Memoranda, 'Investment of overseas funds', Jan/1960-Jan/1962 and Apr/1962

⁶¹⁹ Boughton, 'Northwest of Suez', p437; Klug and Smith, 'Suez and sterling', p193; Kunz, *The economic diplomacy*, pp100-1, 146; Kirshner, *Currency and coercion*, pp67,109

⁶²⁰ RBA:GJP-57-1, Rusden to Phillips, 18/5/1956; TNA:T236/4649, 'The third quarter dollar drain', Butt to France, 12/6/1956; Jenkins to France, 14/6/1956. It looks like the UK official, Butt, who on 12/6/1956 had the bright idea of asking Australia for gold, may have received the idea from Woodrow, the Australian Treasury's officer in London – they were old personal friends and Woodrow had confided in Butt before (TNA:T236/4649, 'Australian gold and dollars', Butt to Armstrong and Rickett, 2/12/1955). For a detailed timeline of this fascinating episode, see Annex 7

analysis of the RBA's files reveals that the sale was being internally debated in early 1956, long before the Suez crisis and sterling's problems of that year.⁶²¹

The second phase, from January 1962 to July 1965, was characterised by debate about reserves (both within the RBA and Treasury), and limited opportunistic diversification. The impetus for change came from Australian misgivings about the UK's EEC application and a dispute with the British over guarantees provided to its partners in the European Monetary Agreement (EMA).⁶²² The Q4 1964 sterling crisis then prompted serious concern about sterling among Australian officials,⁶²³ leading to the request in July 1965 to the Bank of England to provide a dollar guarantee for part (A\$400-500m) of Australia's sterling holdings.⁶²⁴

The third phase, from July 1965 to September 1968, followed the British rejection of Australia's request for a dollar guarantee. Now the RBA planned diversification in earnest.⁶²⁵ The first item on the RBA's list of de-risking measures was the anticipated run-down of sterling through the balance of payments. The second was to build up Australia's IMF gold tranche.⁶²⁶ The full programme of diversification is summarised in Table 6, including the contribution of different measures in 1964-7. Table 6 shows that the reduction in sterling holdings through the balance of payments significantly

⁶²¹ RBA:GJP-57-1, Bryson-Rusden letter, with attachment 'Overseas Assets', 9/2/1956

⁶²² NAA:A571,1961/1966PART2, 'Distribution of international reserves' and 'Attachment: past policy...', appended to Daniel-O'Donnell note, 'Financial implications...', 28/2/1962; RBA:BM-C-181, CBAC Memorandum, 'Protection of reserves...', 25/9/1962. Symons of the UK Treasury highlighted the dispute around the EMA guarantee, following its discovery by the Australians in 1960 (TNA:T267/29, 'Sterling balances', p61). Treasurer Holt saw this as 'evidence of a growing lack of frankness by the UK in its dealings with us... in these currency matters' (NAA:A4940,C3368PART1,946427, 'Implications of United Kingdom entry...', Holt, 27/6/1961). Interestingly, though, it seems that the BOE informed the CBA about the prospect of a reciprocal EMA guarantee, and the CBA Governor tried to tell the Treasury Secretary about it in Apr/1955 (RBA:B.1.1.1.A.65, Coombs to Wilson, 22/4/1955, enclosing 'Convertibility of sterling', 1/4/1955)

⁶²³ RBA:GDS-a-21, Interviews in London, Sanders, 11-18/1/1965; S-h65-137, 'Report of visit to Europe and the USA', 25/6/1965; Memoranda covering Europe/USA discussions, Phillips, Kennedy and Johnston, 9-14/6/1965

⁶²⁴ RBA:S-h65-137, 'Australia and sterling', Commonwealth Treasury, 15/7/1965; RBA:S-h65-137, 'Protection against sterling devaluation', 21-23/7/1965; RBA:IT-a-642-1, 'Sterling reserves', 29/7/1965

⁶²⁵ RBA:IT-a-642-1, Letters, Coombs to Wilson and Holt, 'Sterling reserves', 29/7/1965; RBA:IT-a-642-1, '...the sterling reserve problem', with attachment, '...gold and foreign exchange', 6/8/1965; RBA:IT-a-642-1, 'Maintaining the value...', 11/8/1965

⁶²⁶ RBA:IT-a-642-1, Letters, Coombs to Wilson and Holt, 'Sterling reserves', 29/7/1965; RBA:BM-C-328, CBAC Memorandum, 'Distribution of international reserves', Investment Department, 20/7/1966

exceeded the acts of diversification.⁶²⁷ Apart from gold production and IMF credits, the diversification measures were limited in their aggregate effect (at most A\$46m).

Diversification measure, increasing aggregate non-sterling holdings	When considered or adopted	Cumulative impact, Jun 64–Jun 67 A\$m ⁶²⁸
IMF gold tranche: others' drawings of A\$ at IMF	Aug 1962 ⁶²⁹	67
IMF gold tranche: sterling funding of IMF quota	Aug 1965 ⁶³⁰	7
Retention of loan proceeds	May 1962 ⁶³¹	6*
Earnings on US investments	May 1965 ⁶³²	14
Transfers from FX deals	Aug 1965 ⁶³³	24
Retention of forward dollar contracts from trading banks	Aug 1965 ⁶³⁴	0*
Gold production: retained as gold	Mar 1951 ⁶³⁵	16 ⁶³⁶
Gold production: retained as dollar proceeds	Dec 1951 ⁶³⁷	69
Other including rounding		2
Total of above measures		205
<i>For comparison, reduction of sterling holdings</i>		590 ⁶³⁸

Table 6: Cumulative impact of principal measures to diversify from sterling, 30 June 1964 – 30 June 1967 (A\$m)

Source: Author's calculations from RBA data (see footnotes to Table)

*Note: While these items had a small net cumulative impact over 1964-7, the intervening temporary amounts raised were larger. The retention of forward dollar contracts reached a peak of A\$13m cover in Nov/1965 and was later discontinued.⁶³⁹ The temporary amounts raised through loan proceeds, pending investment, reflected the size of the loans

The above findings do not, of course, negate the role of powerful underlying forces such as changing trade and debt relations in the background thinking of Australian officials about diversification. The point is that these forces only mattered if they resulted in acts of diversification. Apart from newly-mined gold retention, such acts were infrequent, irregular and discrete, not continuous. They were either limited

⁶²⁷ The balance-of-payments effect is shown by the difference between the total reduction in sterling holdings and the total diversification measures. While the Australian Treasury was aware of most of the diversification measures listed, there is no evidence that it was informed about the FX contracts

⁶²⁸ Data extracted and calculated from RBA:BM-Pe-87, Board Memorandum, 'Overseas funds', 'Appendix... international reserves', Nov/1967

⁶²⁹ RBA:BM-C-174, CBAC Memorandum, 'International Monetary Fund...', 2/8/1962

⁶³⁰ RBA:IT-a-642-1, 'Maintaining the value...', 11/8/1965; 'Purchases of forward dollars', Phillips, 20/8/1965

⁶³¹ RBA:BM-C-177, CBAC Memorandum, 'Central bank investments in USA', Investment Department, 29/8/1962; RBA:GHK-65-1, Knight to Hinde, 22/9/1965

⁶³² RBA:BM-Pe-60, Board Memorandum, 'Overseas funds', 'US funds', Investment Department, 19/5/1965

⁶³³ RBA:IT-a-642-1, 'Maintaining the value...', 11/8/1965

⁶³⁴ RBA:IT-a-642-1, 'Maintaining the value...', 11/8/1965; 'Purchases of forward dollars', Phillips, 20/8/1965

⁶³⁵ TNA:T267/29, 'Sterling balances', p60

⁶³⁶ Calculated also partly from data underlying Figure 3. Change in gold holdings (A\$204m – A\$195m = A\$9m) plus gold subscribed for IMF quota (A\$7m)

⁶³⁷ TNA:T267/29, 'Sterling balances', p61

⁶³⁸ Calculated from Figure 3

⁶³⁹ RBA:BM-Pe-87, Board Memorandum, 'Overseas funds', 'Appendix...international reserves', Nov/1967

variations to the pooling rule, discussed with the UK (such as retaining earnings on US investments), outside the pooling rule (such as building up the IMF gold tranche, which was covered by IMF rules) or unobtrusive, hidden measures (such as transfers from FX deals). Officials were not continually targeting a particular sterling share of reserves, which in fact was being driven by the balance of payments. Rather, RBA officials had a normal *modus operandi* which was to follow the pooling rule, while retaining the value of gold production, and any divergence from this established path was a form of 'diversification'. The catalysts for such divergences, in both directions, included: sterling reserves falling below a minimum level at times of balance-of-payments crisis in 1952-61, concern about the UK's 1961 EEC application and the EMA guarantee dispute, and fluctuating worries about the risks of sterling in the 1964-8 years.

Having established when, why and how diversification was put into effect, we can integrate these findings with Singleton and Schenk's account of the constraints on diversification. Their first constraint was 'continued access to the London capital market for government borrowing'. This was particularly important for the Treasury, which, as the authors described, reined back the RBA's diversification demands in the mid-late 1960s. Access to the London debt market was one of the important benefits of sterling area membership, which in turn was the reason why officials followed sterling area pooling rules, so this part of Singleton and Schenk's argument is entirely consistent with the findings of this paper. This paper would only seek to bring into the equation the other benefits of sterling area membership, such as investment of British private capital.

The second constraint on diversification in Singleton and Schenk's paper was 'the drawbacks of alternative assets', a consideration for the RBA as the risk manager. At this time, there were few currency alternatives to the dollar and sterling. However, IMF

credits were an important and available alternative to sterling, and so were US dollars. The argument that officials had a balanced view about sterling relative to the dollar seems more valid for after devaluation than it does for 1962-7. Moreover, the archival record shows a consistent desire on the part of the RBA to get out of sterling. In 1962, the preference of acquiring more gold was not feasible,⁶⁴⁰ and the RBA's first proposal was to increase dollars at the expense of sterling.⁶⁴¹ In August 1962, the risk of sterling devaluation was highlighted, the aim 're-deploying reserves to reduce loss'.⁶⁴² In July 1965, the RBA's preferred ratio of sterling, gold and dollars was stated to be (in A£m) 250:150:250, compared with the actual disposition 500:100:50. Significantly, this was generally agreed by the Treasury Secretary and even discussed with the Bank of England.⁶⁴³ (Note that the preferred figure for sterling – £200m – was the same as the minimum reserve holding discussed in Section 5).⁶⁴⁴ Between 1965 and devaluation in 1967, various papers revealed the RBA's views on sterling (see Table 7). Even in July 1968, the Research Department's view was negative towards sterling and it regarded a 2 per cent interest premium as insufficient compensation for the risks:

'sterling is not very attractive as a reserve asset... There is a case for holding some sterling, but not too much. That case rests largely on desires for access to capital markets and on political associations... Moreover, in view of its basic position, assurances by the U.K. about access to capital may prove unreliable'⁶⁴⁵

⁶⁴⁰ RBA:BM-C-148, CBAC Memorandum, 'Bank's gold holding', Investment Department, 12/12/1961. This paper acknowledged risks for the dollar, and preferred gold, but recognised that additions to gold reserves would need to come from Australian mines, due to UK and USA resistance to gold purchases

⁶⁴¹ RBA:BM-C-154, CBAC Memorandum, 'Australia's overseas reserves', 18/1/1962

⁶⁴² RBA:BM-C-181, CBAC Memorandum, 'Protection of reserves...', 25/9/1962

⁶⁴³ RBA:GJP-74-1, Phillips to Longmuir, 6/7/1965

⁶⁴⁴ The roughly equal split of reserves was justified to the Treasurer using estimates of trade and capital commitments (RBA:IT-a-642-1, 'Aide Memoire...Protection against sterling devaluation', 7/7/1965)

⁶⁴⁵ RBA:BM-Pe-95, Board Memorandum, 'Australia's international reserves', Research Department, 26/7/1968

In short, the RBA's risk assessment on sterling was negative, and the constraint on diversification lay elsewhere.

Date	RBA location	Comment
Aug 65	Investment Department memo	Assuming sterling is devalued in mid-September, we have five weeks to achieve a A\$324m desired switch from sterling into US dollars. ⁶⁴⁶
Oct 65	Board. Aide memoire for Governor	'the immediate prospect for sterling has improved and we are proposing to reduce the extent of our "hedging"'. ⁶⁴⁷
Jul 66	Investment Department memo	Attraction of gold. Diversify from sterling: 'the pattern of action be strengthened where possible without bringing the disposition of our reserves into open discussion in overseas forums'. Deficits should fall on sterling funds, whereas any surpluses should be reflected in increased US funds. Encourage 'further use of Australian currency in IMF drawings and where possible have drawings utilised through sterling'. Consider placing 'an upper limit on our holdings of sterling, say, the level of outstanding official debt in that currency'. ⁶⁴⁸
Sep 66	Advisory Committee (CBAC)	Governor will write to the Treasurer requesting equal split of sterling, gold and dollars (implies A\$450m switch out of sterling and another approach to the UK). ⁶⁴⁹
Sep 67	International Committee memo	'press on with rearrangement of our reserves as far and as fast as we are reasonably able to do' 'we have made it clear to the UK authorities that we cannot give any guarantees as to the future movement of our sterling balances' 'the crunch could come in a major deterioration in our reserves'. ⁶⁵⁰
Nov 67	Advisory Committee (CBAC)	The forward hedging programme could be re-instituted, non-sterling currencies retained from government borrowings, and recent press comment about Australia's diversification might provide cover for more actual diversification. ⁶⁵¹

Table 7: Selected Australian central bank papers about diversifying from sterling, August 1965 – November 1967

Source: RBA (see footnotes to Table)

The third proposed constraint on diversification was 'collective interest in avoiding a collapse in the pound'. There can be no doubt that this was an Australian concern, as Singleton and Schenk pointed out, using evidence from 1967. The phrase is, however, a catch-all, and would include the perceived responsibilities of sterling area membership. It is hard to distinguish 'collective interest' from the sterling area

⁶⁴⁶ RBA::IT-a-642-1, 'Some thoughts...', with attachment, '...gold and foreign exchange', 6/8/1965

⁶⁴⁷ RBA:BM-Pe-65, Board Memorandum, 'Overseas funds', Investment Department, 20/10/1965; 'Aide Memoire...Overseas funds', 26/10/1965

⁶⁴⁸ RBA:BM-C-328, CBAC Memorandum, 'Distribution of international reserves', Investment Department, 20/7/1966

⁶⁴⁹ RBA:BM-C-332, CBAC Minutes, Draft letter (Governor to Treasurer), 1/9/1966

⁶⁵⁰ RBA:GDB-73-1, '...Australia's international reserves', 8/9/1967

⁶⁵¹ RBA:BM-C-370, CBAC Memorandum, 'Appendix, 'Disposition of international reserves...', 2/11/1967

sentiment, expressed by the RBA's London manager in response to the August 1965 diversification plan, 'we have some responsibilities in that broad organisation'.⁶⁵²

On the other hand, it is doubtful that Australia was majorly constrained by a 'sterling trap'. The essence of a currency trap is that diversification is deterred by the consequences for the reserve currency. The RBA's documents suggest that the central bank was concerned more about the visibility of diversification than its consequences for sterling. The aim was, as the RBA's Governor told the Treasurer and Treasury Secretary, 'reducing our sterling risk without attracting attention'.⁶⁵³

The main evidence for the lack of a sterling trap is the scale of Australia's absolute spending of sterling in the 1964-7 years, largely through the balance of payments.⁶⁵⁴ The reduction in sterling holdings was greater than that of any other country, and it was large in relation to the UK's free reserves.⁶⁵⁵ The comparative decline in sterling holdings is shown in Figures 17 and 18. Unlike switching sterling holdings into dollars, spending sterling through the balance of payments was not a breach of the British pooling rule. But if, instead of the pooling rule, we examine the psychology of the 'sterling trap', it does not seem plausible that sophisticated officials who had experienced previous sterling crises – in which the spending of sterling through the balance of payments had been controversial (e.g. 1951-2) – should on the one hand consider switching comparatively small amounts out of sterling too risky for sterling's stability, but on the other hand regard spending sterling in the hundreds of millions as something that had no potential consequences or secondary effects. Yet the RBA was indeed relaxed about the spending of sterling at this time: 'A further heavy reduction in

⁶⁵² RBA:IT-a-642-1, Phillips to Longmuir, 25/8/1965; Longmuir to Phillips, 2/9/1965

⁶⁵³ RBA:IT-a-642-1, Coombs to Wilson and Holt, 'Sterling reserves', 29/7/1965

⁶⁵⁴ There is no implied suggestion that the 1964-8 reserve rundown was an Australian balance-of-payments crisis, as those of the 1951-61 years had been. Indeed (I am grateful to Selwyn Cornish for the following observations), the second half of the 1960s was a period of extraordinary economic expansion for Australia, arguably the high point of this 'golden age', notwithstanding a bad drought around 1965/66, which would have affected rural exports

⁶⁵⁵ Capie, *Bank of England*, pp230-1, Table 5.1

reserves seems inevitable', read one of the November/December 1965 board papers, but due to the level of reserves '...Australia can clearly afford to face a further run down of funds with comparative equanimity'.⁶⁵⁶ It was only natural and right that Australian officials should focus on the Australian reserves position. But, from the perspective of the 'sterling trap' argument, the total reduction in sterling holdings from 1964-7, given also the flight capital to Australia from the UK at the time, can, reasonably, only have contributed to devaluation. This again suggests that officials' thinking primarily reflected the *modus operandi* – the sterling area's pooling rule, rather than a 'sterling trap'.

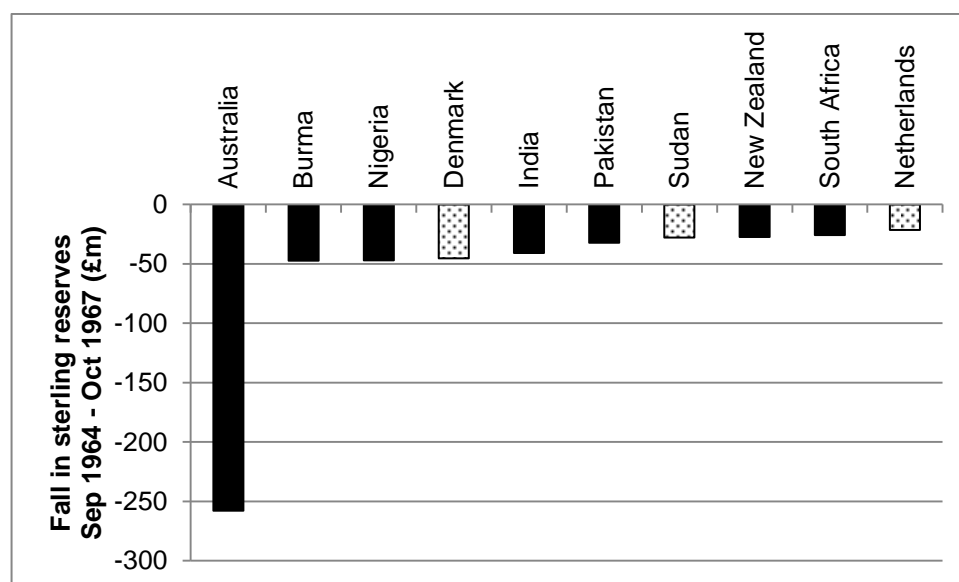


Figure 17: Decline in sterling reserves, the ten countries which showed the largest declines, 30 September 1964 to 31 October 1967 (£m)

Source: Data extracted from monthly reports of the Bank of England's Committee for Overseas Figures. These reports are found in BOE:EID10/1-10 and EID1A129/2-4

Note: Members of the sterling area are shown in black, and other countries with a pattern fill

⁶⁵⁶ RBA:BM-Pe-66, Board Memorandum, 'November/December 1965 Meeting'

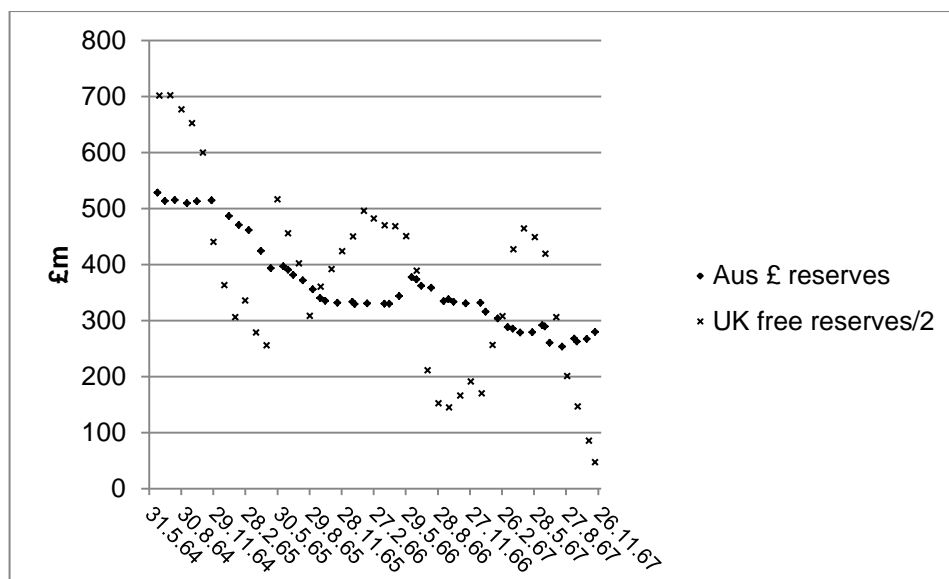


Figure 18: Australia's sterling reserves and half UK's 'free reserves', at various dates from June 1964 – November 1967 (£m)

Source: For UK free reserves, Capie, *Bank of England*, pp230-1, Table 5.1, column (7) (these figures have been converted to sterling at £1=US\$2.8, and divided by two, to show on the same scale as Australia's sterling reserves). For Australian sterling reserves, RBA:BM-Pe-50 to -90, Board Memoranda, 'Overseas Funds'

The dynamics of the reduction in sterling holdings were also inconsistent with a sterling trap, as Figure 18 shows. The direction of the UK's free reserves indicates pressure on sterling. At times of greater pressure (e.g. October 1964-April 1965, June-August 1965, June–August 1966), Australia's holdings were decreasing rapidly. When pressure was less (e.g. September 1965-January 1966), Australia's holdings were stable. There were two occasions when the expected 'currency trap' pattern occurred, with Australia's holdings rising (April-May 1966 and September-November 1967). But this was probably the flight capital from the UK in these months. Table 7 also shows that, at times of greatest pressure (e.g. August 1965 and July 1966), the RBA was calling for more diversification, and when market speculation about devaluation reduced (e.g. October 1965), hedging measures stopped.

In summary, apart from the 1951 gold retention policy, Australia only began actively diversifying from 1962, for reasons that were both political (the UK's EEC application, EMA guarantees) and economic (changing trade and debt relationships, fear of sterling devaluation when the UK joined the EEC). In 1962-7, the RBA was constrained from

diversifying by the government. But there is nothing to suggest that confidence in sterling or the consequences of spending sterling underlay that restriction. The constraint derived primarily from Australia's sterling orientation and membership of the sterling area, which was valuable to Australia. The RBA's preferred holding of sterling was around the minimum operational amount consistent with its sterling orientation through pooling and pegging. In 1952-60 such minimum requirements had at times made Australia a forced buyer of sterling. By 1967-8, Australia's sterling holdings were again close to minimum levels for transactional purposes.

Section 7: Conclusion

This paper has sought to solve a long-standing puzzle – the persistence of sterling in Australia's reserves in the 1950s and 1960s, despite changing trade and debt relationships and an apparent diversification policy dating from the early 1950s. Contrary to such appearances, I argue that Australia largely followed the pooling rule of the sterling area, which did not allow diversification (the substitution of other assets for sterling in a country's reserves). True, in 1951 Australia began to retain newly-mined gold (sometimes converted into dollars through GPA gold sales) rather than sell it to the UK, but this was just a return to pre-1947 policy, and was accepted grudgingly by the British. Apart from this, in 1950-61 Australia followed the pooling rule faithfully, and was even forced by adverse circumstances to sell its valued store of dollars and gold for sterling on several occasions. Given its direct dollar deficit, the pooling arrangements suited Australia. Australia broadly followed the pooling rule even in 1962-8, when it also started to build up its IMF gold tranche and introduced smaller, sometimes hidden, policy adjustments as part of a deliberate diversification strategy. In aggregate, Australia's net addition to non-sterling reserves (i.e. diversification) was little more than its total gold production over the 1951-68 years.

Why then did the literature suggest that Australia was deliberately diversifying from the early 1950s? It is easy to infer this policy from the combination of three factors: firstly, clear indications that Australian policymakers had early concerns about sterling holdings relative to dollars and gold, and were generally pivoting policies away from the UK, as shown by Lee;⁶⁵⁷ secondly, the gold retention policy, which was a genuine risk-driven reaction to these worries (and not in fact motivated by the cited transactional considerations); and thirdly and above all, the decline in sterling's percentage share of Australian reserves during the 1950s. But this last was simply an

⁶⁵⁷ Lee, *Search for security*

automatic by-product of balance-of-payments movements, the effect of declining aggregate reserves against a gradually rising non-sterling holding. 'Diversification' measured in terms of sterling's share of reserves is a misleading term when it is used to imply deliberate policy. It could of course be argued that permitting aggregate (and hence sterling) reserves to decline was itself an act of deliberate diversification. Such an interpretation is questionable. Most of the time, the Australian central bank thought its aggregate reserves inadequate. It bought more sterling when reserves became low. The decline in reserves in the 1950s was the result of a government development agenda, monetary conditions and volatile commodity markets.

That Australia followed the pooling rule so closely, even in the 1960s, is an important new finding, particularly given that some authors thought the pooling arrangements ended in 1958, with sterling convertibility. This restraint shown by Australia in diversifying was, primarily, motivated by the value Australia attached to sterling area membership – the macroeconomic advantages of the sterling peg and pooling arrangements and capital inflow, which provided a stable base for trade and permitted deficit development spending, particularly on imports of capital goods from the United States, and at the same time helped to keep a lid on inflation.

In the mid-late 1960s, the government, prioritising access to capital, played a role in restraint by holding back the central bank from risk-driven diversification. This diversification pressure from the central bank was caused by fear of capital losses, but in fact Australia's sterling borrowings (the separate domain of the Treasury) hedged the reserve assets pretty well. This suggests that the pressure for diversification – evident in a series of central bank papers from 1965 onwards – derived from central bank investment portfolio, not wider economic, considerations. But central bank and government papers from across the whole period, starting in 1951, do not reveal a high degree of confidence in sterling as a reserve currency. If the central bank had not *had*

to sell dollars and gold in order to shore up minimum sterling holdings during the crises of 1951-2, 1955-6 and 1960-1 – sales which have been misinterpreted as motivated by support for the UK – it is doubtful that it would have had other cause to do so. But once the dollars and gold had been sold, the path dependence implicit in the sterling area's pooling rule ensured that they would not be bought back: the slow process of accumulation of gold and dollar holdings through gold production would have to begin again. In this sense, Australia's diversification was institutionally constrained: it was 'blown off course' the policy direction set in 1951.

There were thus secondary feedback effects of its sterling orientation and institutional set-up on Australia's reserve management. These effects included: a need for large minimum sterling holdings due to the volatility of its balance of payments and practices/asset limitations of its note issue fund; immersion in sterling trade transactions due to the widespread impact of sterling area exchange controls; areas of financial dependence on the UK, such as FX dealing and liberal sterling trade credit; and the impact of UK capital flight to Australia.

Singleton and Schenk's paper on Australian reserve management was largely directed at the years from 1968 and the MSP agreements. Its earliest cited evidence for the constraints on diversification is from 1967-8. A major contribution of this paper has been to extend the reserve management evidence to the earlier period of 1950-68. Apart from its focus on the pooling rule and sterling peg, its conclusions differ significantly from those of Singleton and Schenk with regard to the 'how' part of diversification in the 1950s-60s: this occurred largely through gold production and the IMF gold tranche, not through retention of loan proceeds. By focusing on the pooling rule as a *modus operandi*, this paper also alters the nature of the 'when' question too, moving the question away from changes in 'sterling's share', and showing how the UK's EEC application in 1961 marked a turning point towards greater deliberate

diversification by Australia. As regards the 'why' question, Singleton and Schenk focused on debt and trade drivers for diversification, but due to Australia's immersion in sterling trading relationships, these drivers may not have been so strong as previously thought, and in any event, the pooling rule took trade and debt considerations out of the foreground of policy. Sterling was in effect Australia's sole transactional currency, while gold, dollars and the IMF gold tranche were its 'rainy day fund'. This paper does not address the years from 1968, when doubts about the dollar relative to sterling would have increased following the devaluation of sterling. But its conclusions may help to explain some of the phenomena observed in the later period. For example, Singleton and Schenk's finding that the MSP contracts were rarely binding on Australia⁶⁵⁸ could reflect the need for a minimum sterling buffer above the contracted MSP, a margin of safety given Australia's balance-of-payments volatility.

When talking about feedback effects and restraints, one should not go too far. In the background, if not the foreground, the changing trade and debt picture for Australia was not so different from its actual diversification through gold production. And while central bank concerns about sterling were particularly strong from 1965, the build-up of the IMF gold tranche provided a partial and timely response. So it would be wrong to argue that the policies followed were somehow directly enforced by the British, or costly and uncongenial to Australian policymakers in a macroeconomic sense. They were rational. The paper's contribution is rather in establishing accurate facts around the microeconomics of Australia's reserve management. The effects of the microeconomics were not mere details, however. It is telling that the methods Australian officials chose to diversify – gold production, the IMF gold tranche, careful marginal variations of policies discussed with the British, or hidden, unobtrusive FX transactions with Australian counterparties – did not majorly confront or challenge the sterling area's pooling rule. It is telling that Australian policymakers in 1965 were

⁶⁵⁸ Singleton and Schenk, 'The shift', p22

careful about switching, but relatively relaxed about spending, sterling reserves. This suggests that the rules of the sterling area mattered. The sterling area system had significant effects on its members in the 1960s, just as it had in the 1950s. It may have been an anachronism, but it was far from irrelevant. Australia was arguably the most important member of the sterling area outside the UK, and the various elements of its reserve management experience are likely to have been found in other members.

This explanation of Australia's policy can be considered alongside the three competing claims about why independent sterling area countries persisted with sterling in the 1950s-60s. Firstly, Australia's following of sterling area rules might be judged a kind of loyalty (Eichengreen's argument). Loyalty seems the wrong word, though, and supposed acts of loyalty, such as the 1956 Suez gold sale, turned out to have been driven by Australia's need for sterling. I agree with Singleton and Schenk's assessment that the policy was driven by rational self-interest. Australia benefited from membership of the sterling area and so it was natural to want to be seen to be following the rules.

Secondly, might Australia's sterling area behaviour and retention of sterling be described as a negotiated outcome, secured by British concessions (Strange's argument)? The implied bilateral contract of sterling area membership could be characterised as a negotiation, yet here too it feels like the wrong word. Year by year, there was little that needed negotiation. These were the established sterling area rules, and Australia largely followed them. This paper has looked only at the Australian perspective and so, while it argues that Australian officials saw clear benefits, it cannot comment on the costs or benefits of the arrangement for the UK.⁶⁵⁹ It could be argued that the UK set the rules and through them secured as much sterling area co-operation as it could muster.

⁶⁵⁹ For a view on the UK question, see Schenk, *Britain*

Thirdly, Australia's sterling area behaviour was in large measure consistent with being restrained by the costs of switching (Schenk's argument). The sterling area offered benefits. Access to the London capital market and a sense of collective interest (Singleton and Schenk's institutional arguments) were also part of the sterling area network package. Some of Singleton and Schenk's conclusions are not supported. There was little confidence in sterling in 1962-7, and a clear policy statement in 1965 that the disposition of reserves was too heavily weighted towards sterling – not where the RBA or Treasury wanted them to be. Officials were only partly, not overly restrained by fear of harming sterling (a 'sterling trap'), because Australia spent large volumes of sterling in 1964-8, mainly through the balance of payments, but also through deliberate diversification, 'reducing our sterling risk without attracting attention'. In not diversifying more aggressively, Australian officials were taking a holistic view of transaction needs, the benefits of sterling area membership, the risk of devaluation and the UK relationship.

The starting point of this paper was the lessons to be derived from sterling's past. What insights for reserve currencies emerge from Australia's case? Firstly, there is the idea that sterling's historic persistence means continued leadership for the US dollar, supported by inertia. Here this paper's conclusion is negative. It confirms the scepticism of Eichengreen and Schenk about the current power of inertia based on this historical precedent: it casts doubt on the applicability of sterling's persistence in the 1950s and 1960s to the US dollar today.⁶⁶⁰ Sterling's persistence within the sterling area derived from a unique institutional context of sterling area rules which no longer exists. Because sterling's international role relied on the holdings of sterling area countries, it was a somewhat artificial world currency and had nothing like the current market-based position of the dollar.

⁶⁶⁰ Schenk's arguments, about the mitigating role that major external support can provide to a currency in decline, still hold (Schenk, *The decline*). But Schenk was clear that this was a carefully managed process and a product of its time (Schenk, 'The retirement')

Secondly, Australia's case does suggest the subtle power of the institutional arrangements underlying informal alliances. There was no written agreement between the UK and Australia before the MSP contracts, only national laws. Yet dollar settlement in intra-sterling area trade was forbidden, despite the non-discrimination rules of Bretton Woods. Australia's reserve management was significantly influenced by its membership of the sterling area. The world may now be moving away from multilateralism in the direction of a new 'minilateralism' of regional alliances and soft law,⁶⁶¹ so it is important to study these phenomena. Informal alliances may – even today – have the power to skew the disposition of reserves, as was the case in the sterling area.

Thirdly, we saw that it was not just the sterling area that affected Australia; Australia arguably also had an impact on sterling, through changes in its sterling holdings. Commentary on the prospects for international currencies today usually focuses on their risk and return characteristics. But large changes in aggregate reserves are not typically driven by considerations of relative risk and return. In recent years, emerging market countries have significantly increased their aggregate reserves for reasons both precautionary and mercantilist.⁶⁶² These changes may have a sound rationale, but the accumulation and in turn spending of such reserve piles have consequences for the reserve currencies concerned. The case of Australia's sterling is a reminder, to today's reserve currency issuers – despite trust in currency traps – that ultimately the fate of their currency rests, unpredictably, in the hands of others.

⁶⁶¹ Brummer, *Minilateralism*

⁶⁶² Aizenman and Lee, 'International reserves'; Aizenman and Pinto, 'Managing'

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NAA	National Archives of Australia, Canberra
BOE	Bank of England Archive, London
TNA	The National Archives of the UK, London

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The rules of the sterling area, 1950-68

The rules for each sterling area member were unwritten, ill-defined and subject to negotiation and change over time. They were clearly bilateral between each country and the UK: the UK's implicit agreement with Australia was different from that made with, say, Burma, Hong Kong, Kuwait or South Africa. Membership of the sterling area was the UK's sole decision. The rules can be broadly categorised into five areas, as set out in the Table:

Rule	Description and comment
The 'peg'	Exchange rate pegged to sterling. Since it was possible to devalue or revalue against sterling, and exchange rates were generally fixed rate in the Bretton Woods system (1946-71), this was not a particularly onerous additional requirement in practice, but would have become much more so if sterling had floated
The 'pool'	All receipts of dollars, gold etc should be sold in exchange for sterling. In return the Bank of England should not refuse requests for dollars and gold when sterling was presented to it. Note that the pool was a concept rather than a physical thing. The currency exchanges did not have to be executed directly with the Bank of England: sometimes the Bank encouraged dealings through authorised banks in London. An exception to the rule of the pool was that, subject to negotiation, some countries were allowed to retain limited and usually static 'pots' of gold and dollars for specific purposes (e.g. to back the local currency). South Africa was not part of the pooling arrangements. Australia was unusual in retaining a growing pot of gold and dollars, a source of friction with UK officials
The controls	Each country should maintain exchange controls against the non-sterling area well-aligned with those operating in the UK. There were some troublesome weak control points in the sterling system (Hong Kong, Kuwait, British West Indies), but Australia's controls were tight. Meanwhile the UK's own rules allowed unrestricted capital movement from the UK to sterling area members
Consultation	Close consultation in a number of areas: usually weekly statistical information on sterling holdings provided by central banks to the Bank of England; a committee of Commonwealth representatives in London meeting a number of times a year; regular, usually annual, gatherings of Commonwealth Finance Ministers, officials and statisticians
Co-operation	There had been some concerted macroeconomic and import restraint co-operation in the late 1940s with the aim of protecting sterling, but by the early 1950s this had effectively broken down and never revived

Table A1: The rules of the sterling area, 1950 – 1968

Source: Author's assessment, based on numerous sources. For example, for the peg, see Perkins, *Britain and Australia*, pp148-9. For the pool and controls, see Schenk, *Britain*, p26. For consultation and co-operation, see RBA:B.1.1.1.A.65.2, Extract, Commonwealth Liaison Committee minutes, 'The Sterling Area system', 12/12/1951. For general detail, e.g. the view on co-operation, see TNA:T267/29, 'Sterling balances'. Records of meetings of the Commonwealth Liaison Committee and meetings of Commonwealth Finance Ministers are widely spread in TNA e.g. in the DO35/ and CAB133/ series and elsewhere

The above were the principal sterling area rules considered by this paper. But it should be said that this customary formulation has drawbacks. As already noted, the sterling peg already lay within the fixed exchange rate framework of Bretton Woods, and in 1962 Perkins was arguing that changes in sterling's parity might not have to be matched in full by Australia as a sterling area member, even if sterling were to float.⁶⁶³ With respect to the pool, RSA countries diversified their reserves to varying degrees (see Annex 2), and South Africa was not part of the pool arrangements at all. And there were significant lacunae – e.g. free exchange markets in Hong Kong, Kuwait – in the exchange control framework: these were also tolerated by the British.

This suggests that the UK was prevented from enforcing rules (e.g. breaches of the pool rule), as it had an interest in maximising the scale of the sterling area and its reputation as a voluntary organisation of countries holding sterling on the currency's own merits. Expelling members (Burma, Southern Rhodesia) or blocking sterling balances (Egypt, Southern Rhodesia) risked frightening others about the sterling area's viability. An internal 1957 debate within the Bank of England and Treasury about whether to expel India given its diversification plans produced the realisation that it was better, for the sake of sterling, to keep India inside the tent: India's diversification from sterling would be more constrained.⁶⁶⁴

Certain rules seem to have been applied without exception, indicating a hard core to the system. One was the rule of intra-sterling area trade settlement (see Table 4 in this paper). As also discussed in this paper, the UK consistently refused all requests for gold or dollar guarantees from RSA countries, even while granting such guarantees to NSA countries, until the general MSP agreements of 1968.⁶⁶⁵ Another rule concerned speculating against sterling. A UK official document in 1966 stated: 'it is against the

⁶⁶³ Perkins, *Britain and Australia*, pp148-9

⁶⁶⁴ BOE:OV56/92, documents, 30/1-4/2/1957

⁶⁶⁵ Schenk, *The decline*, pp273-316 discusses the MSP agreements

rules of the “Sterling Area Club” for OSA central banks to take forward cover’.⁶⁶⁶ In short, the UK expected RSA countries to earn their membership by trusting in sterling. From the British perspective, trust in sterling was arguably the guiding principle of the sterling area.

⁶⁶⁶ BOE:EID10/25, ‘The Sterling Balances’, 9/12/1966, sent by the Foreign Office and Commonwealth Office to ‘certain overseas missions’

Sterling's share of international reserves 1950-67

ANNEX 2

%	Dec 1950	Dec 1951	Dec 1952	Dec 1953	Dec 1954	Dec 1955	Dec 1956	Dec 1957	Dec 1958	Source
Australia	93	88	84	87	83	73	79	84	77	(1)
Australia						73	80	84	78	(2)
NZealand	83	83	82	88	86	81	88	83	86	(1)
NZealand									80	(2)
S Africa	48	46	45	20	39	18	29	-5	5	(1)
S Africa						25	35	8	19	(2)
India	88	87	86	85	85	86	78	68	57	(1)
India						84	79	69	59	(2)
Pakistan	96	91	80	79	80	79	76	74	69	(1)
Pakistan						66	65	59	47	(2)
Ceylon	96	92	91	85	88	85	80	79	76	(1)
Ceylon						83	77	75	66	(2)
Iraq	98	92	92	94	97	93	92	87	84	(1)
Burma						55	88	76	74	(2)
Ireland						74	81	78	77	(2)
Kuwait						96	97	97	95	(2)
Libya						75	83	88	89	(2)

%	Dec 1959	Dec 1960	Dec 1961	Dec 1962	Dec 1963	Dec 1964	Dec 1965	Dec 1966	Oct 1967	Source
Australia	79	74	84	76	80	79	70			(2)
Australia						79	70	69	60	(3)
NZealand	79	72	96	96	95	96	95			(2)
NZealand						98	97	97	85	(3)
S Africa	28	2	8	8	5	3	6			(2)
S Africa						5	9	4	7	(3)
India	56	47	43	40	45	43	39			(2)
India						44	40	20	21	(3)
Pakistan	59	68	63	61	66	59	56			(2)
Pakistan						60	56	46	32	(3)
Ceylon	56	84	81	80	85	83	85			(2)
Ceylon						94	88	87	90	(3)
Burma	76	87	70	61	69	29	10	2		(2)
Ireland	71	73	75	77	76	88	88			(2)
Ireland						83	83	87	85	(3)
Kuwait	95	95	86	77	73	67	67			(2)
Kuwait						67	67	62	74	(3)
Libya	44	60	80	67	43	28	30			(2)
Libya						22	24	28	18	(3)
Malaysia						99	95			(2)
Malaysia						96	96	90	82	(3)
Singapore						100	98	93	50	(3)
H Kong						100	100	100	100	(3)
Ghana		96	93	93	91	91	91			(2)
Ghana						91	91	91	90	(3)
Nigeria			90	88	83	84	84			(2)
Nigeria						88	85	79	66	(3)

Table A2: Sterling's share of reserves in selected sterling area countries, end-month, December 1950 – October 1967 (%)

Source: (1) Calculated from data in Schenk, *Britain*, Appendix, pp50-1, and Table 2.5, p30, using an exchange rate of £1 = US\$2.80 (2) Extracted from BOE:OV44/115 (3) Extracted from BOE:OV44/116. All were based on BOE sterling data and IMF non-sterling data

Note: In the case of (1) I did not use the percentage share figures calculated by Schenk and published in *Britain*, Table 2.4, p30, and *The decline*, Table 3.1, p89, as they looked on the low side and appeared to employ a different exchange rate, but did use the underlying data presented by Schenk. Caution is advised for all sources: for instance, the sterling data in (1) included non-official reserves, while (3) referenced official reserves

ANNEX 3

Monthly reports to RBA board on US dollar and gold investments, 1960-2

Date	NY Funds (US\$m)	Gold Holding (US\$m)	Combined Holding (US\$m)	Commentary at RBA board (to save space, this does not include monthly comment on RBA acquiring gold production)
10/1/60	85.4	153.1	238.5	USA: little change
15/2/60	85.7	158.0	243.7	USA: little change
7/3/60	85.7	159.6	245.3	USA: unchanged
8/4/60	85.7	164.2	249.9	USA: unchanged
13/5/60	85.8	167.5	253.3	USA: virtually unchanged. NY loan proceeds \$23.9m of which \$20m sold for £, balance retained in NY to cover current dollar requirements
20/6/60	85.8	171.4	257.2	USA: unchanged
18/7/60	81.6	149.8	231.4	USA: \$4m Treasury bills run off, proceeds used for current dollar requirements. Gold: \$25m equivalent delivered to IMF to cover the gold element (25%) of IMF quota increase
15/8/60	74.6	152.7	227.3	USA: \$7m Treasury bills run off, proceeds used for current dollar requirements
19/9/60	71.1	158.0	229.1	USA: \$3.5m Treasury bills run off, proceeds used for current dollar requirements
17/10/60	66.8	158.1	229.1	USA: \$4.5m Treasury bills run off, proceeds used for current dollar requirements. Gold: first GPA sale for \$ since Sep 1959, proceeds \$1.1m used for current dollar requirements
14/11/60	59.8	147.9	207.7	USA: \$7m Treasury bills run off, proceeds used for current dollar requirements. Gold: GPA sale (206k oz) for \$. Proceeds \$7.3m used for current dollar requirements. Gold sale via Bank of England 'as part of the programme to meet the rundown in overseas funds': 300k oz sale order of which 214k sold this month
16/1/61	48.5	146.2	194.7	USA: \$11.3m Treasury bills run off, proceeds used for current dollar requirements. Gold: GPA sale for \$. Proceeds \$2.9m used for current dollar requirements. Gold sale via BOE: 88k oz
13/2/61	48.5	146.8	195.3	Gold: GPA sale (121k oz) for \$. [No comment made about use of \$4.3m proceeds, but it would be consistent with the static US\$ holdings and the prior and following month use of proceeds that these would be for current dollar requirements]
13/3/61	48.4	148.9	197.3	USA: virtually unchanged. Gold: GPA sale for \$. Proceeds \$1.1m used for current dollar requirements. CHF60m loan: proceeds converted into sterling, £5.8m
17/4/61	48.4	151.6	200.0	USA: unchanged. Gold: GPA sale for \$. Proceeds \$3.4m taken into working balances overseas
15/5/61	48.4 A£21.6	[152.5] A£68.1	[200.9]	USA: unchanged. Gold: GPA sale for \$. Proceeds \$2.2m taken into working balances overseas
16/6/61	[49.7] A£22.2	[153.7] A£68.6	[203.4]	USA: increase reflects GPA sale proceeds. Gold: GPA sale for \$. Proceeds \$2.2m: \$1.1m taken into working balances overseas and \$1.1m invested in US Treasury bills

Continuation of Table				
Date	NY Funds (US\$m)	Gold Holding (US\$m)	Combined Holding (US\$m)	Commentary at RBA board (to save space, this does not include monthly comment on RBA acquiring gold production)
12/7/61	[49.7] A£22.2	[152.1] A£67.9	[201.8]	USA: unchanged. Gold: GPA sale for \$. Proceeds [\$4.7m] A£2.1m taken into working balances overseas. NY Loan: proceeds \$23.6m, \$2.5m to Commonwealth Australia, \$21.1m to RBA (of which \$19m sold for sterling and \$2.1m retained against current dollar expenditure)
9/8/61	[49.7] A£22.2	[151.6] A£67.7	[201.3]	Gold: GPA sale for \$. Proceeds [\$3.4m] A£1.5m taken into working balances overseas
6/9/61	[53.3] A£23.8	[151.4] A£67.6	[204.7]	USA: increase reflects GPA sale proceeds. Gold: GPA sale for \$. Proceeds [\$3.4m] A£1.6m added to US investments
11/10/61	[55.6] A£24.8	[152.5] A£68.1	[208.1]	USA: increase reflects GPA sale proceeds. Gold: GPA sale for \$. Proceeds [\$2.2m] A£1.0m added to US investments
15/11/61	[55.6] A£24.8	[157.5] A£70.3	[213.1]	USA: unchanged
10/1/62	[56.7] A£25.3	[160.6] A£71.7	[217.3]	USA: increase reflects GPA sale proceeds. Gold: GPA sale for \$. Proceeds [\$1.1m] A£0.5m added to US invested funds. Netherlands NLG loan (first for Australia): proceeds of NLG38.1m converted into sterling, £3.8m

Table A3: Monthly reports to RBA board on US dollar and gold investments, selected details, 10 Jan 1960 to 10 Jan 1962 (US\$m unless otherwise indicated)

Source: RBA:BM-Pe-1 to -23, extracted from Board Memorandum, 'Investment of Overseas Funds'

Note: items in square brackets [] are author's calculations, using exchange rate of A£1 = US\$2.24, and other observations. All references to \$ in this Table are to US\$

Example scanned documents: contributory changes to sterling holdings of Central Bank and Trading Bank, monthly report from London

2a

CENTRAL BANKPrincipal Movements in London Funds from 30th June to 28th July, 1954000's omitted

	<u>Receipts</u>	<u>Payments</u>
1. Australian Banks (including Trading Bank, Comptoir National d'Escompte de Paris, Bank of China and Bank of New Zealand)	2,840	23,054
2. <u>Commodities</u>		
Ministry of Food	2,605	
Wheat Committee	372	95
3. <u>Currency Transactions</u>		
T.T. New York	53	214
T.T. Ottawa	-	598
4. Commonwealth of Australia	991	2,232
5. <u>State Government Accounts</u>		
New South Wales		590
Victoria		-
Queensland		10
South Australia	29	99
Western Australia		235
Tasmania		14
6. <u>Treasury Bills</u>		
Interest on Treasury Bills	281	
Treasury Bills bought from or sold to N.I.D.	-	
Interest on above	-	
7. <u>Other Transactions</u>		
Dividends due and paid		804
Westralian Farmers Transport	40	13
I.C.E.M.	101	38
Prem. purchase British Government short dated stocks		350
Prem. sale British Government short dated stocks	22	
Reserve Bank of New Zealand	360	
Melb. & Met. Board of Works	1,753	1,773
Sinking Fund Purchases		37
City of Sydney Interest	32	
Australian Notes Purchased		20
	<u>9,479</u>	<u>30,176</u>

TRADING BANKPrincipal Movements in London Funds from 30th June to
28th July, 1954000's omitted

	<u>Receipts</u>	<u>Payments</u>
1. Central Bank	1,200	9
2. <u>Bill Transactions</u>		
B/Rs, B/Cs and Ls/C	1,965	
Barley Board	671	
B/Ns, B/Cs and Ls/C		1,026
Ls/C - Tea		1,498
3. Sundry Warrants, M.Ts., T.Ts, and current accounts	778	1,281
4. Foreign Banks	114	599
5. Purchases and Sales of Foreign Currency	2	127
6. <u>Other Large Transactions</u>		
British Phosphate Commissioners		142
General Electric Co.		204
Standard Vacuum Oil Co.		1,012
Westralian Farmers Transport	96	43
Bank of Ceylon	158	
Bank of Indonesia	18	
General Motors		17
City of Sydney Interest		32
Royal Bank of Canada		21
T.T. to Honiara (Copra)	216	
T.T. to Sydney (Weddel & Co)	200	
National Bank of Pakistan	16	
	<u>5,434</u>	<u>6,011</u>

Calculation of a transactions index for Australia: trade share and debt share indices

The aim of the transactions index is to provide a very approximate indication of Australia's transactions orientation towards sterling. Therefore the methods of construction have been kept simple.

Trade share index (25 per cent weight in transactions index)

The IMF Historical Direction of trade statistics provide a picture of Australia's trade orientation in terms of different countries, UK, USA and others. These country trade data have regularly informed reserve management studies such as that of Singleton and Schenk. But, as a new contribution, this study has unearthed valuable *currency* share of payments data in two accounting years, 1953-4 and 1963-4. These are assumed from the context to be trade payments – to the extent that they included debt payments, the trade payments would have been even more oriented towards sterling.

Figure A1 shows the different share figures.

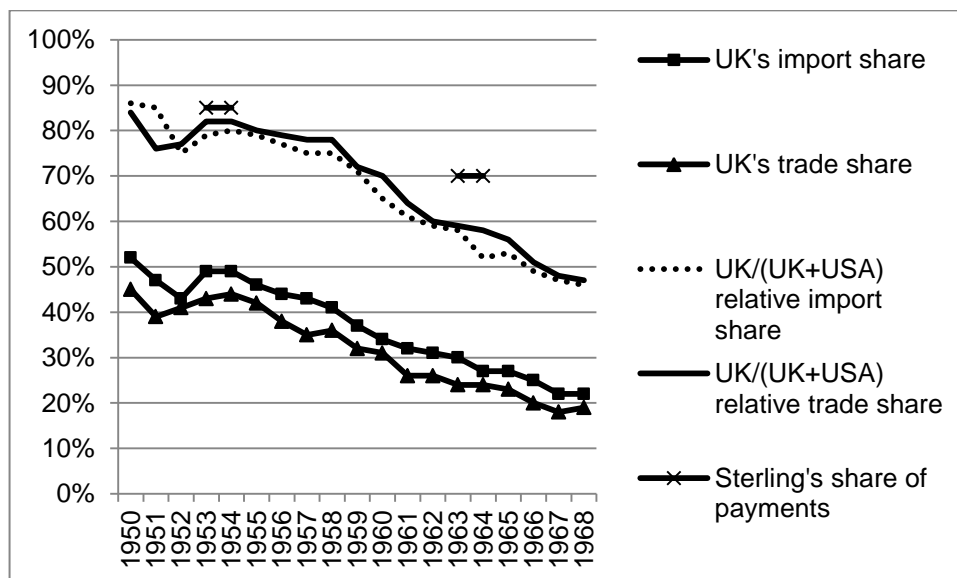


Figure A1: Relative shares of UK in Australia's trade and imports, and of sterling in Australia's payments, 1950 – 1968 (%)

Source: For sterling's share of payments, RBA:BM-Pe-56, Board Memorandum attachment, 'Investment of overseas funds', Investment Department, 21/1/1965. For all other shares, calculated from IMF Historic Direction of Trade Statistics (data extracted on 4 Aug 2017 10.08 GMT from UKDS.Stat)

Since the currency payments share is more relevant for the transactions theory, I decided that the trade share index should be derived from the more extensive data for the UK's overall trade share, but should be consistent with (pass through) the two data points for sterling's payments share. The main uncertainty was how to treat the currency denomination of Australia's trade with other countries than the UK or USA. From this study, it was clear that much trade with Europe and Japan and other regions was sterling-denominated in the 1950s, but became more US dollar-oriented towards and in the 1960s. A simple mechanism was required to express this. By setting a 95 per cent sterling weight (5 per cent for dollars) for trade with other countries in 1950, and multiplying this declining sterling weight each subsequent year by 0.985, the resulting trade share index was consistent with (passed through) the sterling payments share data points. It is possible that this trade share index may understate the decline in sterling's share around the time of Japan's switch from sterling to dollars around 1960, and also in the latter years (1965-8) when Australia was substituting Australian dollar trade for sterling trade e.g. with New Zealand, but there was not enough information to finesse all these aspects, or the rate of attrition before they happened, and a simple rule seemed adequate for these purposes.

Debt share index (25 per cent share in transactions index)

I am indebted to the Australian Office of Financial Management for data about the currency of Australia's overseas debt, from 1950. Singleton and Schenk also used this data, in order to calculate sterling's share of debt for Australia, but it is instructive to look at the gross debt figures first. This is set out below in Figure A2.

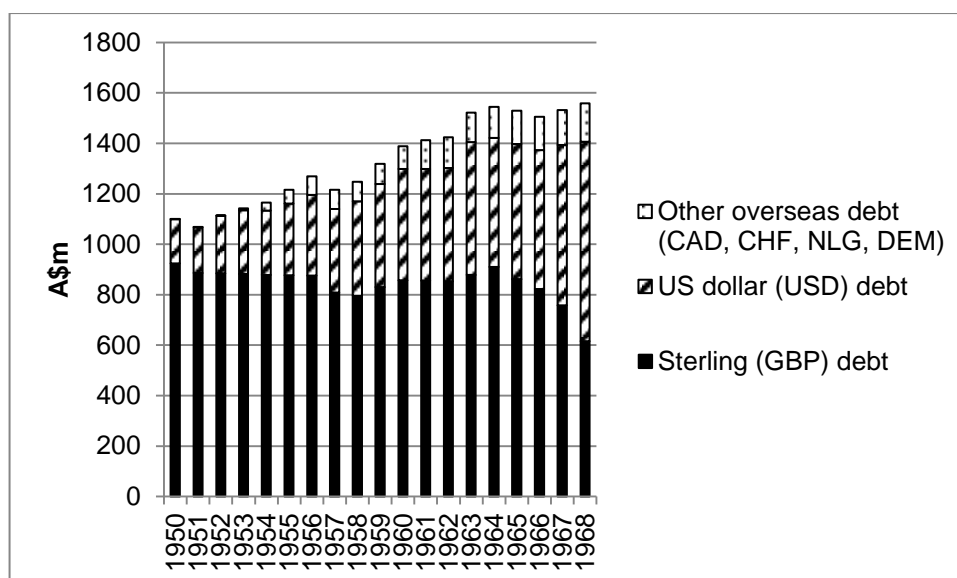


Figure A2: Australia's securities domiciled overseas, by currency, as at 30 June, 1950 – 1968 (A\$m)

Source: Australian government, 1974-75 Budget Paper No.6, Table No.6 (Thanks to Australian Office of Financial Management)

In the sterling crisis period of 1964-8, there was a sharp decline in the volume of sterling debt outstanding. From the point of view of theory, this is counterintuitive.

Dooley, Lizondo and Mathieson (DLM) argued that it was rational for countries to issue more debt in order to reduce their net exposure to a currency at risk.⁶⁶⁷ I did not specifically investigate the reasons for this decline, but noted that (a) there were likely to have been (sterling crisis-driven) constraints on debt issuance in sterling by Australia in this period – a board paper in July 1968 stated:

'The U.K. has already heavily restricted our access to its capital markets and our official sterling debt outstanding has fallen by \$193 million (excluding the effects of devaluation) since 1964'⁶⁶⁸

I also formed the strong impression that (b) the reserve management by the RBA (in Sydney) and the debt management by the government (in Canberra) were separate

⁶⁶⁷ Dooley, Lizondo and Mathieson, 'Currency composition'

⁶⁶⁸ RBA:BM-Pe-95, Board Memorandum, 'Australia's international reserves', 31/7/1968

and uncoordinated, and the debt management was driven more by access considerations than exchange rate risk factors.

DLM looked at the cost of servicing outstanding currency debt, but for these purposes a simple debt share approach seems adequate. If we had used the cost of servicing, due to higher interest rates in the UK, the debt share index and transactions index would have been even more oriented towards sterling. Again the key question is how to treat other (non-sterling, non-dollar) debt: should one regard it as sterling-equivalent, dollar-equivalent, or neither? Singleton and Schenk showed sterling's share in overall debt in their paper, in order to demonstrate Australia's overall commitment to sterling. But, for this debt share index, in a binary sterling-dollar transactions currency comparison, that approach (the bold line in Figure A3) implicitly treats the other debt as dollar-equivalent. I decided to take the neutral approach and focus only on the dollar and sterling debt (the dashed line) to form the debt share index.

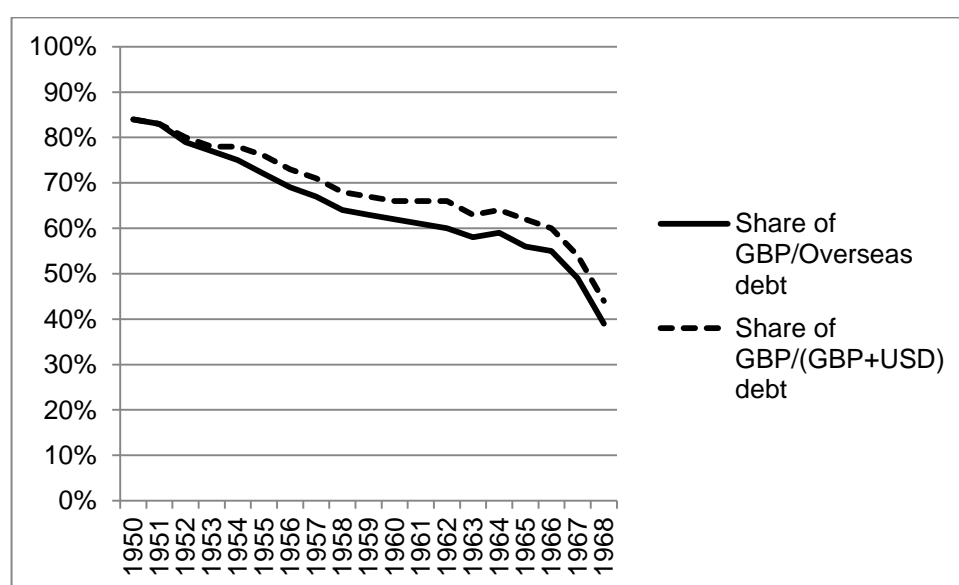


Figure A3: Sterling's share of Australia's securities domiciled overseas, as at 30 June, 1950 – 1968 (%)

Source: calculated from data in Figure A2

Balance sheets of the Central Banking Business and Note Issue Department

Figures A4 and A5 show the balance sheets of the Central Banking Business and the Note Issue Department, in terms of composition of assets. In the case of the Central Banking Business, 'Other' was a broad category dominated by 'Loans, Advances, Bills Discounted and All Other Assets', while in the case of the Note Issue Department, 'Other' was negligible. The remaining principal asset categories for each fund were 'Gold and Balances Held Abroad (including Money at Short Call)' (shorter-term), 'Other Overseas Securities' (longer-term investments)⁶⁶⁹ and 'Australian Government Securities (including Treasury Bills and Treasury Notes)'. The Figures use the same vertical scale so that they can be compared in terms of magnitude.

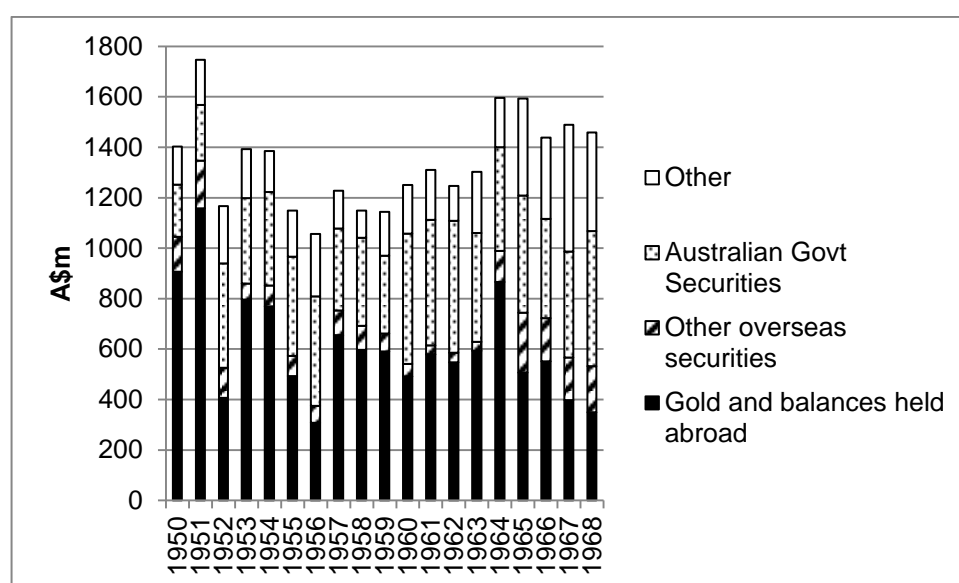


Figure A4: Composition of assets in Australian central bank's Central Banking Business, as at 30 June, 1950 – 1968 (A\$m)

Source: White, *Australian banking*, p57

Note: Other = Total Assets less all other categories listed; Australian Govt Securities includes Treasury Bills and Treasury Notes; Gold and balances held abroad includes money at short call

⁶⁶⁹ White, *Australian banking*, p17

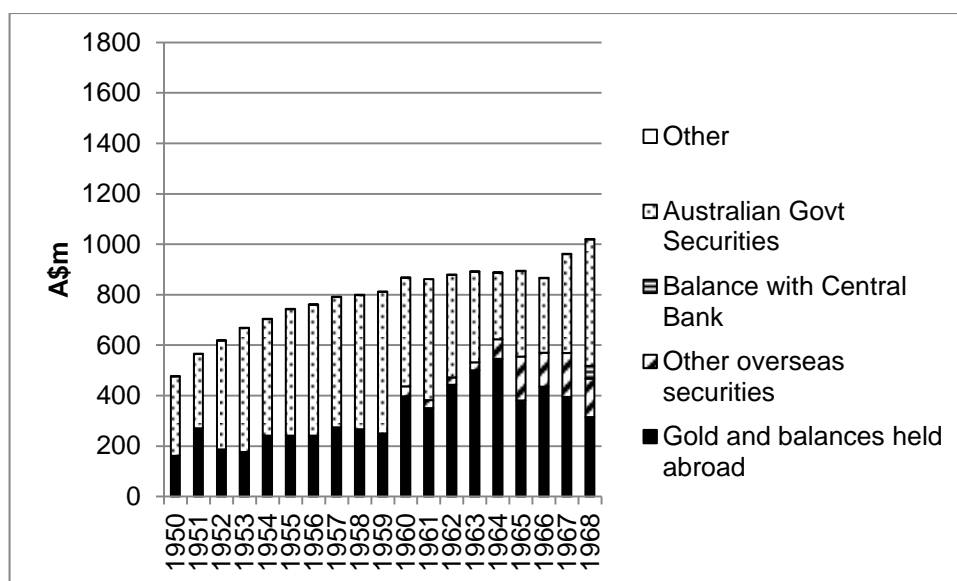


Figure A5: Composition of assets in Australian central bank's Note Issue Department, as at 30 June, 1950 – 1968 (A\$m)

Source: White, *Australian banking*, p57

Note: Other = Total Assets less all other categories listed; Australian Govt Securities includes Treasury Bills and Treasury Notes; Gold and balances held abroad includes money at short call

In Figure A5, the temporary dip in the note issue assets at June 1966 presumably reflects the February 1966 re-monetisation from the Australian pound to the Australian dollar. The A\$50.8m balance with the central bank arose after the November 1967 devaluation of sterling, which would have left a hole in the Note Issue Department, which held no reserve capital.⁶⁷⁰ The effect of the UPD policy in March 1960 is also clearly visible with the growth of external assets at the expense of Australian assets. We saw in Figure 3 that by 1964, with balance-of-payments inflows, sterling assets had reached a high level across the central bank as a whole. The UPD consequently raised the proportion of external assets (i.e. gold and sterling) in the Note Issue Department. Also visible from 1964 is the aforementioned investment in British government securities (contained in 'Other overseas securities'), lengthening the maturity of assets backing the 'hard core' minimum sterling reserves.

If the UPD policy was operating consistently from 1960, one would expect the ratio of {Gold and balances held abroad plus Other overseas securities} to {Australian

⁶⁷⁰ See White, *Australian banking*, pp15, 17

government securities} to be the same across the two funds. Figure A6 shows this in fact to be the case. The only minor discrepancy is in June 1961. However, the April 1961 IMF drawing, held in sterling, was part of the assets of the Central Banking Business and did not then form part of the UPD calculation, so this divergence is explained. This is circumstantial evidence, therefore, that the UPD policy was being consistently followed after 1960.

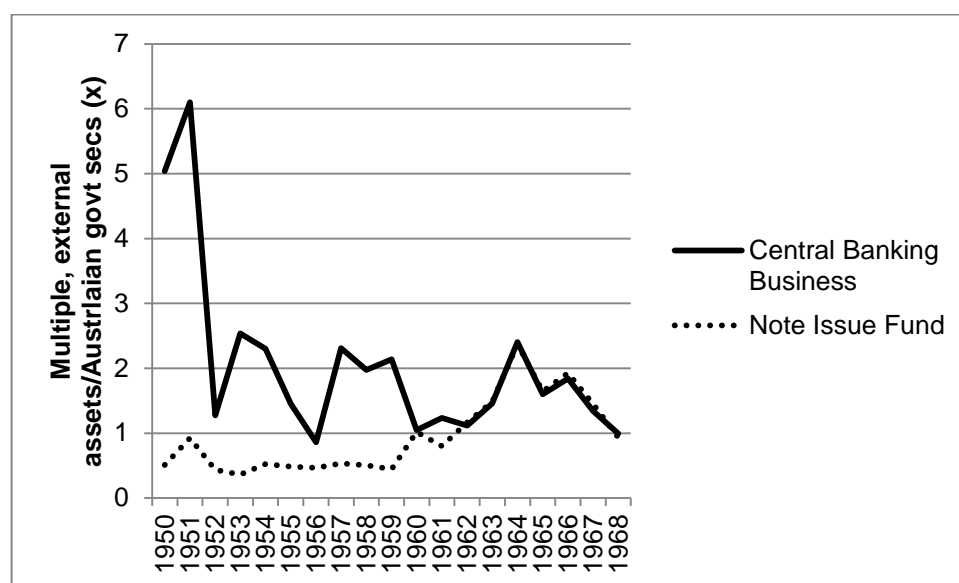


Figure A6: Ratio of gold and overseas assets to Australian government securities in Australian central bank's Central Banking Business and Note Issue Department, as at 30 June, 1950 – 1968 (multiple)

Source: Calculated from relevant asset categories in Figures A4 and A5

It is possible to show, by way of numerical example, how the combination of the UPD and the no-dollar rule of the note issue fund, together with other constraints, *might* have constrained an RBA seeking to minimise sterling holdings. The 'Other' assets were not part of the UPD policy. So it is necessary to consider the balance sheet of the two funds, *excluding the 'Other' assets*, so as to give Total gold and investments (TGI) as at the end of June 1967, and assume that the UPD policy was operating. Gold holdings were limited by gold production: let us assume that gold holdings were constrained to 10 per cent of the combined external holdings and Australian government securities holdings (TGI). Australian government securities holdings (short- and long-dated) were also affected by monetary policy: let us assume that

these were constrained to 40 per cent of the combined external and Australian government securities holdings. Finally the rest of the holdings were in the form of external money markets and external government securities holdings – 50 per cent of the total. These rough proportions are not far from those actually prevailing, based on the RBA data underlying Figure 3.

Now assume that the RBA was seeking to minimise sterling holdings and maximise dollar holdings, but was constrained to hold a minimum of A\$250m equivalent of sterling in the London funds (in line with the minimum buffer findings), with all the other external holdings in US dollars. On these assumptions, the sterling holdings of the note issue fund are in effect determined (and consequently sterling's share of gold and currency reserves is determined) by the respective sizes of the Central Banking Business and the note issue fund. The results are displayed in Table A4.

A\$m		CBB	NID	Total CB	
Total assets (actual at 30 June 1967)		1489	962	2451	
Less 'Other' assets (actual)		503	1	504	
Equals TGI (Total gold and investments)		986	961	1947	
	Assumptions			Predicted	Actual CB
Gold	Constrained to equal 10% of TGI	99	96	195	204
Sterling	Minimise holding A\$250m in CBB	250	481	731	723
US dollars	Maximise holdings in CBB	243	0	243	209
Australian govt secs	Constrained to equal 40% of TGI	395	384	779	812
Sterling's share of gold and currency reserves				63%	64%

Table A4: Effect of Uniform Proportionate Distribution policy on the assets of the RBA's Central Banking Business and Note Issue Department, as predicted by assumptions; and actual holdings, as at 30 June 1967 (A\$m)

Source: Total assets and 'Other' assets calculated from White, *Australian banking*, p57; all other figures derived from assumptions. 'Actual CB' assets from data underlying Figure 3

Note: CBB = Central Banking Business; NID = Note Issue Department; CB = central bank; TGI = total gold and investments, being Total assets less 'Other' assets.

That the predicted holdings and the actual holdings of gold, sterling and US dollars are similar in this numerical example is not surprising, since this arises from the convenient assumptions made about gold and Australian government securities. However, the point about this mechanism is that, if the Central Banking Business assets had been

A\$200m less, perhaps because of a different balance-of-payments outcome, and the assets of the Note Issue Department A\$200m more, perhaps because of differences in the public's demand for money, there would have been an impact on predicted sterling holdings, despite no change in gold or Australian government securities holdings occurring: sterling reserves would have been A\$831m, not A\$731m, and sterling's share of gold and currency reserves would have been 71 per cent, not 63 per cent. Thus even a central bank determined to maximise dollar holdings *might* have been constrained by the Note Issue Department arrangements, or would have been compelled to change these arrangements. Indeed, in the year to June 1969, the note issue's balances with the central bank were significantly increased to A\$303.6m. White described the reason for this as follows:

'Limitation on the types of assets the Note Issue Department can hold, imposed by Section 38 of the *Reserve Bank Act*, and changes in the disposition of the Bank's overseas investments combined to increase the difficulty in maintaining a suitable distribution of investments between the central bank and the Note Issue Department... The Note Issue Department deposit is maintained at a level which is related to the proportion of overseas funds which lies outside the scope of authorised Note Issue investments'⁶⁷¹

This citation, while outside the period of this study, suggests that the RBA found a solution to the legal asset limitations of the Note Issue Department.

It should also be noted that the 1945 central bank legislation and successive legislation had not been intended to constrain the central bank, rather, in fact, to release it from constraints. This point was made by the then Governor in his report on the legislation in 1945. He wrote:

⁶⁷¹ White, *Australian banking*, p17

‘The abolition of the Note Issue Reserve, and power to mobilise gold and foreign exchange means that, should pressure on overseas funds arise, Australia will be in a much stronger position to meet her overseas payments’⁶⁷²

Therefore, to the extent that the RBA had faced the ‘difficulty’ referred to in the preceding citation from White, and resolved in 1968-9, this was arguably just a fortuitous consequence of the adoption of the 1960 UPD policy. So we should be cautious in attributing too much significance to the contribution of the Note Issue Department to the sterling orientation of the reserves.

⁶⁷² RBA:Annual Report, Governor’s Report, pp14-5, 5/9/1945. I am grateful to Selwyn Cornish for bringing this citation to my attention

ANNEX 7

Background to Australia's September 1956 gold sale

1956	Form	People	Content
9 Feb	Letter	Bryson (head of investments, CBA Sydney) to Rusden (head, CBA London)	Predicts a precipitous decline in London funds from £130m (end-December 1955) to £59m by end-September 1956. To shore up sterling liquidity, possibilities are sales of British government securities, transfer of Treasury bills from Note Issue Department, or sales of dollars or gold. ⁶⁷³
18 May	Letter	Rusden (head, CBA London) to Phillips (acting head of investments, CBA Sydney)	After successful April sale of dollars, responds to a Sydney query on possible sale of gold. I have deliberately not consulted Bank of England but 'I think it most likely that it would suit the Bank of England to buy gold from you and hold it ear-marked in Australia'. ⁶⁷⁴
12 Jun	Memo	UK Treasury. Butt to Jenkyns, copied to France	(Short memo seemingly out of the blue). 'A bright idea for what it is worth'. Some of Australia's gold and dollars might help us with a difficult third quarter. ⁶⁷⁵
14 Jun	Memo	UK Treasury. Jenkyns to France, copied to Armstrong	Response to Butt's memo: notes that, in Canberra recently, Randall (Australian Treasury) told me 'Australia would sell us gold if we were in difficulty'. ⁶⁷⁶
1 Aug	Letter	Haslam (Bank of England) to Jenkyns (UK Treasury)	Response to Jenkyns' request for advice. Says asking Australia for gold would be 'most unwise'. Better timing would be a proper sterling crisis. ⁶⁷⁷
10 Aug	N/A	UK Treasury. Rowan (Head of Overseas Finance), Macmillan (Chancellor)	By this date, Rowan has proposed idea of request for Australian gold sale to Chancellor Macmillan, ahead of a forthcoming meeting with the Australian Prime Minister Menzies. ⁶⁷⁸
20 Aug	Meet	London: Macmillan (UK Chancellor), Menzies (Australian Prime Minister)	Macmillan asks Menzies for gold and at the meeting Menzies reacts 'very favourably'. Figure of £20m mentioned. ⁶⁷⁹
20 Sep	Ledger	Bank of England	£20m gold sale recorded in Bank of England ledger (held ear-marked in Australia). ⁶⁸⁰

Table A5: Documentary timeline for Australia's September 1956 gold sale, February – September 1956

Source: See footnotes to Table

⁶⁷³ RBA:GJP-57-1, Bryson to Rusden, with attachment 'Overseas Assets', 9/2/1956

⁶⁷⁴ RBA:GJP-57-1, Rusden to Phillips, 18/5/1956

⁶⁷⁵ TNA:T236/4649, 'The third quarter dollar drain', Butt to France, copied to Jenkyns, 12/6/1956

⁶⁷⁶ TNA:T236/4649, 'The third quarter dollar drain', Jenkyns to France, copied to Armstrong, 14/6/1956

⁶⁷⁷ BOE:OV13/18, 'Gold – Australian borrowing in London', Haslam to Jenkyns, 1/8/1956

⁶⁷⁸ TNA:T236/4649, 'Australia', Rickett to Petch, 10/8/1956

⁶⁷⁹ BOE:OV13/18, 'Australia – gold', Bailey to Parsons, Chief Cashier, Governor, 20 Aug 1956

⁶⁸⁰ The purchase, just over £20m of gold from Perth No.1 Account, on 20/9/1956, is recorded in the Bank of England's gold ledgers (BOE:2A141/10). RBA:GJP-74-1, Phillips to Mutton, 18/8/1960, shows that periodic sales of gold to the Bank of England were held in this form. In 1960, as the Bank of England moved the gold out of Australia, some of the Australian press wrongly interpreted the move as gold losses by Australia (the topic of the letter)

Chapter 3. Escape from ‘tranquillity’? How TK Whitaker centralised and diversified Ireland’s currency reserves after the 1967 devaluation of sterling⁶⁸¹

Section 1: Introduction

Since the 1990s there have been debates about the merits of currency boards. A currency board is a rule-based institution, which solidly fixes the country’s exchange rate against a selected reserve currency, and ensures that its monetary base of notes and coins is backed by such external reserves. Advocates of currency boards prize their stabilising discipline relative to central banks.⁶⁸² Critics regard them as inflexible and more appropriate to colonial times.⁶⁸³ Some see a possible role for them in small, open economies, or as a transitory confidence-building device after political change.⁶⁸⁴ Exit from a currency board can be traumatic, as in the case of Argentina in 2002,⁶⁸⁵ while sometimes the transition from currency board to central bank goes smoothly.⁶⁸⁶

One often-cited example of a country that successfully transitioned from a currency board to a central banking system is Ireland in the late 1970s. Ireland’s central bank in the 1950s-70s has been called the ‘tranquil currency board’.⁶⁸⁷ Starting as a post-independence currency board in 1928, it had been granted central bank powers in the Central Bank Act 1942, but in practice little discretion was exercised and currency board rules were followed virtually until 1979, when the Irish pound’s one-for-one ‘sterling link’ with the British pound ended upon the former’s entry into the European

⁶⁸¹ I am grateful for the assistance of staff at the Central Bank of Ireland Archive, the National Archives of Ireland, National Library of Ireland, UCD Archives, Bank of Ireland Archive, RBS Archive, The National Archives of the UK and Bank of England Archive. Anne Chambers provided helpful answers to questions about TK Whitaker and his time. Eoin Drea provided guidance on sources. Duncan Farquhar gave helpful comments on an earlier draft. During drafting, Olivier Accominotti and Joan Rosés provided helpful feedback. All errors are my own. TK Whitaker died in early 2017, at the age of 100. This article records an aspect of his public service to Ireland

⁶⁸² Hanke, ‘Currency boards’; Schuler, ‘Currency boards’

⁶⁸³ Schwartz, ‘Currency boards’; Williamson, *What role*

⁶⁸⁴ Balino and Enoch, *Currency board arrangements*

⁶⁸⁵ De La Torre et al, ‘Living and dying’

⁶⁸⁶ Malaysia, Singapore and Ireland are referenced in Balino and Enoch, *Currency board arrangements*, pp26-7

⁶⁸⁷ Wolf et al, *Currency boards*, p. 11

Monetary System. Ireland's monetary arrangement of 1950-1979 has been described as a successful transitory system for an economy with conservative financial traditions and close cultural and economic integration with the UK.⁶⁸⁸ A number of authors have described how the Central Bank of Ireland (CBI) progressively acquired more powers over decades⁶⁸⁹ so that, 'the almost orthodox currency board gradually morphed into an active central bank'.⁶⁹⁰

This chapter revisits Ireland's experience with a currency board in the 1950s-70s and explores why the country eventually escaped this monetary arrangement. I first show that Ireland's tripartite 'currency board system' did not really meet the orthodoxy requirements of the currency board advocates, differing from the ideal in several ways, such as monetary financing of public sector deficits. While one of the usual goals of this type of arrangement is to release monetary policy from political pressures, Ireland's currency board did not prevent the government from monetising its debts in the 1950s-70s.

Second, I revisit the timing of Ireland's move from a currency board to a central banking system and argue that this move took place much more abruptly than usually described in historical accounts. Most of the significant changes in the transition from currency board to central bank occurred in the years 1968-72 after, and partly as a result of, the 1967 devaluation of sterling. Ireland's transition to a central bank was made possible through two decisive and inter-related events: the centralisation of the sterling reserves of the commercial banks into the central bank, in 1968-9; and the diversification of Ireland's external reserves away from sterling, which began in earnest in 1968 and took sterling's share of Irish reserves from 90 per cent in 1967 to less than 20 per cent in 1975.

⁶⁸⁸ Honohan, 'Currency board'

⁶⁸⁹ Moynihan, *Currency and central banking*; Moynihan, 'The central bank'; Honohan, 'Currency board'

⁶⁹⁰ Wolf et al, *Currency boards*, p. 11

Why did reserve centralisation and diversification occur at that specific time and not sooner? Sterling's devaluation of 1967 played a critical role in these events. Before the devaluation, Irish policymakers had avoided diversifying their reserves away from sterling because they remained faithful to their sterling area commitments. However, the UK decision to devalue the pound sterling in 1967 was a game-changer in that it was perceived in Ireland as a breach of the UK's obligation towards members of the area. Released from their sense of duty, Irish monetary authorities could now freely and massively diversify their reserves into other currencies. At the same time, in an effort to appease sterling area members, the UK government offered a dollar guarantee to official holders of sterling, and this provided incentives for a centralisation of the commercial banks' sterling reserves into the CBI. Therefore, Ireland's switch to a modern central banking system, which was delayed for a long time by its adherence to the sterling area system, was suddenly precipitated by external events and another crisis affecting its traditional anchor currency.

The chapter relies on evidence from three types of sources: published financial data, original material from the central bank and government archives, in both Ireland and the UK, and the historical records of two out of the four Irish commercial banks ('Associated Banks'),⁶⁹¹ namely Bank of Ireland and Ulster Bank. These sources allow me to provide a detailed account of the centralisation and diversification events following the 1967 sterling crisis. Although access to commercial bank archives was limited, evidence from two of these banks confirms the general story emerging from the data and the documents in the central bank.

⁶⁹¹ The Associated Banks (i.e. commercial banks associated with the CBI as former shareholders of its predecessor, the Currency Commission) were Bank of Ireland, with Hibernian Bank and National Bank of Ireland, both of which it had absorbed by 1965; Provincial Bank of Ireland, Royal Bank of Ireland and the Munster & Leinster Bank, which all merged to form Allied Irish Banks in 1966; Ulster Bank and Northern Bank. The latter two banks, each with substantial Irish business, were headquartered in Belfast and owned by British banks, Westminster Bank (now RBS) and Midland Bank (now HSBC) respectively. By the late 1960s, Bank of Ireland and Allied Irish Banks were clearly the dominant players in Irish commercial banking

The argument proceeds as follows. Section 2 surveys historical context, literature, data and sources. Section 3 reviews the orthodoxy of the tripartite Irish financial system, extending the scope of Honohan's currency board study. Section 4 provides an account of the centralisation of reserves at the CBI, placing it in the context of the broader evolution from currency board to central bank. Section 5 considers diversification from sterling, before and after 1967. Section 6 sets out conclusions.

In 1927, a few years after independence, Ireland established a national currency, the 'Irish Saorstat pound', fully convertible into sterling on a no-margins one-for-one basis, supported by a Currency Commission. Commercial banknotes were to be gradually phased out.⁶⁹² Unlike, say, Australia, holdings of foreign currency were not mobilised by the state, and sterling circulated widely.⁶⁹³ The country emerged from neutrality in the Second World War with, on the one hand, a mature private banking system averse to state interference, and, on the other, governments which became focused on full employment and growth, primed through credit-funded state spending. The CBI had been created in 1943 as a compromise and interlocutor between these conflicting interests. A state-owned organisation, it had potentially wider powers than its predecessor the Currency Commission, but, as will be seen, its limited resources and constitution constrained the exercise of those powers. Ireland's 'official external reserves' were divided between banks, government and CBI. Each was responsible for the management of its own patch.⁶⁹⁴ For this paper, it is important to understand the Irish tripartite financial system, which collectively controlled credit in Ireland.⁶⁹⁵ Each element (banks, government and CBI) is discussed below.

There were initially eight 'Associated Banks', formerly the shareholders of the Currency Commission. By 1966, they had effectively been reduced to four in number, dominated by Bank of Ireland (BOI) and Allied Irish Banks (AIB), which each emerged from a three-bank consolidation. The Associated Banks were older than the Irish state, and, partly also through business in Northern Ireland, had close links with the UK banking

⁶⁹² Some banks had previously issued their own banknotes but all issuance ceased after 1953 and by 1960 such notes represented less than 0.4% of all notes and coin (Moynihan, *Currency*, pp512-3)

⁶⁹³ Honohan, 'Using other people's money', p37

⁶⁹⁴ Despite the government's influence on the CBI, the Minister for Finance (MfF) replied to a question in the Dáil on 10/12/1968: 'the employment of the funds in the custody of the Central Bank is a matter for the Bank' (UCDA:P175/89, 'Central bank and government, 1969-76', 'XI Management of external reserves', Whitaker)

⁶⁹⁵ Meenan, *The Irish economy*, p366

system. They had resisted the establishment of the central bank.⁶⁹⁶ They deposited their excess liquidity in London because of the lack of an Irish money market. They were organised through a cartel, the Irish Banks Standing Committee (IBSC). Bank of Ireland, once a contender to have been Ireland's central bank, and still holder of the government's Exchequer account, was the acknowledged leader of the group and chaired the IBSC.⁶⁹⁷ The 'official external reserves' managed by the banks were taken to be the 'net external assets' of the Associated Banks.⁶⁹⁸ While the Associated Banks could deploy their assets in foreign currencies other than sterling, they were also tasked with policing exchange control through their monitoring of exchange transactions. Exchange controls were supposed to prevent transfers of capital outside the sterling area.

The government's 'official external reserves' were held in a variety of funds, known as 'Departmental Funds', and were dominated by the assets of the Post Office Savings Bank (POSB), initially held largely in sterling. Responsibility for the management of these assets rested with the Department of Finance (DF) and its powerful Secretary (TK Whitaker,⁶⁹⁹ from 1956 to 1969), reporting to the Minister for Finance. Until 1972, the government maintained a policy of balancing its current budget, but from 1950 there was also a capital budget financed both through spending of the Departmental Funds, and also borrowing from banks, the non-bank sector, the CBI and abroad.⁷⁰⁰ Most borrowing was conducted through scheduled issuance of Exchequer bills to the banks, and longer-term National Loans⁷⁰¹ to the public. Ireland was a creditor nation

⁶⁹⁶ O'Broin, *No man's man*, p148

⁶⁹⁷ The IBSC's address was that of BOI

⁶⁹⁸ The non-Associated Banks had net external liabilities. They were a hotchpotch of merchant, foreign commercial and industrial (hire purchase) banks (CBI:Report of the Money Market Committee, hereafter 'MMC Report'). By the mid-1960s they were experiencing rapid growth, partly because of the licensing regulations. Until the Central Bank Act 1971, a new bank could be licensed in Ireland, without recourse to the CBI, for the cost of £1

⁶⁹⁹ Whitaker has been called the architect of modern Ireland (Chambers, *T.K. Whitaker*). After his stint as DF Secretary, he became Governor of the CBI (1969-76). He was the main political actor in the centralisation and diversification events described in this paper

⁷⁰⁰ Whitaker, *Interests*, pp83, 98

⁷⁰¹ Underwritten, and sometimes subscribed by, the banks

and, apart from a brief external foray in 1966 (the first in around 40 years) did not borrow overseas until the 1970s.⁷⁰²

Under the Central Bank Act 1942, the CBI's general function and duty consisted of 'safeguarding the integrity of the currency and ensuring that, in what pertains to the control of credit, the constant and predominant aim shall be the welfare of the people as a whole'.⁷⁰³ However, until the granting of its licensing⁷⁰⁴ and supervisory powers in the Central Bank Act 1971, it had no tools with which to restrict credit.⁷⁰⁵ 'The integrity of the currency' also was a vague phrase. Whitaker said it simply meant defending the parity with sterling.⁷⁰⁶ The CBI's assets were divided between two funds, a Legal Tender Note Fund (LTNF), a continuation of the Currency Commission's function, and a smaller General Fund (GF) which was supposed to support other central bank roles such as acting as lender of last resort (LLR) to the banks. The CBI's board, ruled by consensus, was inherently conservative. Although the Governor and membership were formally appointed by the Minister for Finance, the eight-man board had to include at least three Associated Bank-sponsored 'banking Directors' and no more than two 'service Directors' employed by the state, of whom one was typically the Secretary of the DF.

Meenan wrote that the balance of payments, not emigration, was the 'true problem of the Irish economy' in the 1950s-60s, indicating that increased exports were needed to support living standards, employment and development.⁷⁰⁷ Though the 1950s were troubled by stagnant growth, resulting in a 'critical juncture'⁷⁰⁸ in policy around 1958

⁷⁰² Whitaker, *Interests*, pp196-7

⁷⁰³ Central Bank Act 1942

⁷⁰⁴ Formerly this was a matter for the Revenue Commissioners

⁷⁰⁵ The CBI could only encourage lending, by ordering non-interest bearing deposits with it, if a bank was deemed to be holding too many external assets. This latter provision was controversial in the negotiations over the Central Bank Act 1942, unpopular with the Associated Banks, and was never used

⁷⁰⁶ Whitaker, *Interests*, pp177-85

⁷⁰⁷ Meenan, *The Irish economy*, p292

⁷⁰⁸ See Donnelly and Hogan, 'Understanding policy change', McCarthy, *Planning Ireland's future*, for the 'critical juncture' in Ireland associated with the publication of *Economic Development* in 1958

(from import substitution to encouragement of FDI and export-led growth), there were only short periods of external reserve loss during which the sterling parity seemed under special pressure, when interest rates or credit conditions were out of kilter with those in the UK (e.g. 1955-6 or 1965-6). In most years after 1956 the country's current account deficit was at least matched by capital inflows. Total official external reserves were more under pressure in the 1950s (especially 1950-1 and 1955-6), and stable to increasing in the 1960s, as Figure 1 shows. Against average *total* official external reserves in the 1950s-60s of just over £240m, these were not severe fluctuations. Irish retail prices closely tracked those in the UK, even though running slightly ahead of the UK in the 1960s, and despite faster growth/lower velocity in wider money.⁷⁰⁹

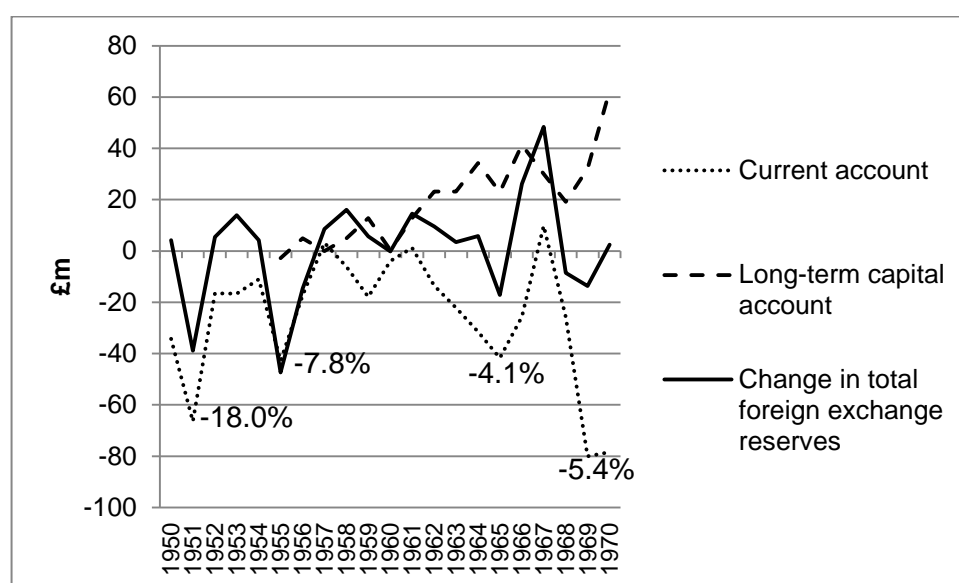


Figure 1: Ireland's current account, long-term capital account, and change in total foreign exchange reserves, annually during year ended 31 December, 1950 - 1970 (£m)

Source: Current account: Bielenberg and Ryan, *An economic history*, 'Statistical appendix, Table 4'; Change in total foreign exchange reserves: calculated from Moynihan, *Currency*, pp538-9; Long-term capital account: from Mitchell, *International historical statistics*

Note: Current account deficit as percentage of GNP shown in figures for 1951, 1955, 1965 and 1969

The debate about the merits of currency boards has principally revolved around the more recent ('new') operators of currency board systems, such as Hong Kong,

⁷⁰⁹ Honohan, 'Currency board', p50; Honohan and O'Grada, 'Irish macroeconomic crisis', p75

Argentina, Estonia, Lithuania, Bulgaria, and Bosnia-Herzegovina.⁷¹⁰ For instance, in the case of Hong Kong, there have been opposing views about whether Hong Kong would have been better served by its currency board or the more flexible ‘monitoring band’ operated by Singapore.⁷¹¹ The Argentina debate concerns the extent to which the currency board contributed to the 2001-2 crisis, with complexity arising from differing views about what the currency board’s job was – simply to bear down on inflation or to instil wider macroeconomic discipline and stability. Reviewing the debate, Wolf et al concluded that it succeeded in the former but failed in the latter.⁷¹² The Baltic countries were assessed according to the appropriateness and credibility of their currency boards relative to independent central banks and flexible exchange rates – on the whole, these boards were considered to be appropriate (particularly Estonia’s), the main negatives being the weak LLR function and an increasing misalignment of the real exchange rate.⁷¹³ Key issues in analysis of the merits of currency boards therefore include their motivation (e.g. credibility after hyperinflation – Argentina and Bulgaria – or credibility and stability after independence – the Baltic countries, Bosnia-Herzegovina: Ireland would also be in this latter category). Other issues include whether they are intended as foreseeably permanent (e.g. small, open countries, which might even include a larger open economy responding to financial crisis, like Hong Kong in 1983) or as transitory, aimed at a further objective (e.g. joining the euro, for the European countries). For the transitory boards, it is argued, there should be an exit plan.⁷¹⁴

For Ireland, it is clear that the Central Bank Act 1942 intended a transition to full central bank status in conjunction with an indefinite fixed exchange rate to sterling, and

⁷¹⁰ For broader treatments, see Balino and Enoch, *Currency board arrangements*; Wolf et al, *Currency boards*

⁷¹¹ Jao, ‘The working’; Kwan and Lui, ‘Hong Kong’s currency board’; Rajan and Siregar, ‘Choice of exchange rate’; Tam, ‘A new comparative study’

⁷¹² Wolf et al, *Currency boards*, pp117-43

⁷¹³ De Haan, Berger and Van Fraassen, ‘How to reduce’; Wolf et al, *Currency boards*, pp148-72

⁷¹⁴ Balino and Enoch, *Currency board arrangements*; Wolf et al, *Currency boards*

probably an indefinite sterling exchange standard.⁷¹⁵ In other words, the relevant choice was not (viz the Hong Kong, or Baltic states literature) between a currency board and a floating rate of exchange, but between a currency board and a standard peg managed by a central bank (on the 1844 Bank of England ‘issue department’ model).⁷¹⁶ Chang and Velasco’s theoretical framework suggested that, while a floating exchange rate with LLR is more beneficial, a standard peg, with limited central bank lending to commercial banks, should provide higher welfare than an orthodox currency board, but is more prone to bank runs than the currency board. Bank runs can be reduced by a ‘war chest’ approach of high bank reserves, but this comes at a high social opportunity cost.⁷¹⁷ So there were theoretical welfare reasons for making the transition towards a softer peg. However, what the CBI lacked at the outset was resources, and certain functions which impinged on the Associated Banks (to act as banker to the banks and government, to restrict credit, or to engage in open market operations given the lack of a domestic money market).⁷¹⁸ A currency board’s operation does not encourage, and possibly discourages, independent central bank policy capacity.⁷¹⁹ That it took 30 years to start to make this transition suggests that the intended transition lacked a viable exit plan, and faced some countervailing resistance.

Perhaps reflecting the blurred line between currency board and central bank, Schuler, an advocate of currency boards, did not initially recognise Ireland in 1943-79 as a currency board system,⁷²⁰ while describing Malaysia in 1959-67 as ‘a currency board system with a dormant central bank’⁷²¹ (a phrase which might have applied equally well to the CBI in its early years). Indeed Ireland’s currency board has usually been

⁷¹⁵ Moynihan, *Currency*, pp309-10

⁷¹⁶ Schuler, ‘Currency boards’, pp29-33, argued that the 1844 BOE model of issuing department and banking department – akin to the CBI’s LTNF and GF – was not a currency board

⁷¹⁷ Chang and Velasco, ‘Financial fragility’

⁷¹⁸ Moynihan, *Currency*, pp309-10

⁷¹⁹ Kopcke, ‘Currency boards’

⁷²⁰ Schuler, ‘Currency boards’, pp91-4

⁷²¹ Schuler, ‘Currency boards’, p169

grouped among the 'old' (colonial) currency board systems,⁷²² even though its original 1927 set-up came after independence and so was similarly motivated to that of Estonia. It was Honohan who pointed out that the CBI was operating a currency board system at least until the early 1970s, so that the years afterwards until 1979 formed the 'true transition' from currency board to central bank.⁷²³ Referencing Honohan, Wolf et al said the change began with the resumption of modest lending (1955-6) and culminated in the abandonment of legislative approval for parity changes (1971).⁷²⁴ Also referencing Honohan's article, Balino and Enoch's gradual change story mentioned a dilution in the reserve backing rule (1961), modest lending to banks and government (1965), the parity rule change (1971) and the abandonment of the sterling link (1979).⁷²⁵ Meenan highlighted as key events the rediscounting of Exchequer bills (1956), the CBI's issuance of credit advice to banks (moral suasion – 1965), and the transfer to the CBI of the Associated Banks' net external assets (1968-9) and the government's Exchequer account (1972).⁷²⁶

A definition of an orthodox currency board was provided by Hanke, a currency board advocate:

'An orthodox currency board issues notes and coins convertible on demand into a foreign anchor currency at a fixed rate of exchange. As reserves, it holds low-risk, interest-bearing bonds denominated in the anchor currency and typically some gold. The reserve levels are set by law and are equal to 100 percent, or slightly more, of its monetary liabilities (notes, coins, and if permitted, deposits)... Its operations are passive and automatic. The sole

⁷²² Wolf et al, *Currency boards*, pp7-24

⁷²³ Honohan, 'Currency board', p42

⁷²⁴ Wolf et al, *Currency boards*, p11

⁷²⁵ Balino and Enoch, *Currency board arrangements*, p27. They claimed that 1965 was the first CBI lending, but this was a misreading of Honohan, since rediscounting of bills began in 1955-6

⁷²⁶ Meenan, 'The evolution'. See also McGowan, *Money and banking*, pp78-94; CBI:Chronology

function of a currency board is to exchange the domestic currency it issues for an anchor currency at a fixed rate.⁷²⁷

The main difference between the balance sheet of a central bank and an orthodox currency board is that a central bank holds some domestic assets (typically government debt) while a currency board does not.⁷²⁸ Because it has no domestic assets, an orthodox currency board operates a hard exchange rate peg, fixed usually by statute, with no ability to conduct monetary policy or to act as LLR to the banking system.⁷²⁹ Balino and Enoch argued that the credibility of a currency board arrangement (CBA) depends on three rules: the reserve backing and hard exchange rate rules listed above, and a third unwritten rule:

‘While large excess reserves can strengthen a CBA, they must be used in a way that clearly subordinates concerns over monetary and banking sector developments to the objective of preserving the parity... their credibility depends as much on attitudes as on rules and institutions’⁷³⁰

This unwritten rule is a particularly interesting question in Ireland’s case. Did the currency board foster fiscal discipline? Jao highlighted Hong Kong’s fiscal surplus,⁷³¹ but some authors claimed that the Argentinian currency board failed to encourage fiscal discipline.⁷³² The same complaint was raised against that of Bosnia-Herzegovina, where credit growth was effectively uncontrolled because it was endogenously financed by foreign currency deposits made by the commercial banks’ foreign owners.

⁷²⁷ Hanke, ‘Currency boards’, p88

⁷²⁸ Williamson, *What role*, p3

⁷²⁹ Hanke, ‘Currency boards’, pp90-2

⁷³⁰ Balino and Enoch, *Currency board arrangements*, p4

⁷³¹ Jao, ‘The working’

⁷³² De La Torre et al, ‘Living and dying’; Wolf et al, *Currency boards*, pp117-43

Gedeon argued that, because of the money creation flaw, this orthodox currency board was 'called to active duty' to control bank liquidity and reserve requirements.⁷³³

So long as its assets were only sterling and (a little) gold, the CBI's LTNF met Hanke's technical definition precisely. Its liabilities were the Irish note issue alone and, dealing with the banks, it exchanged Irish notes for sterling and vice versa without margin or commission. Asset cover was 100 per cent. The parity with sterling could only be changed by statute. The LTNF was therefore certainly a currency board. Under the Central Bank Act 1942, a unanimous CBI board decision supported by Ministerial order could widen the LTNF's eligible assets without needing the approval of the Irish parliament. But these orders were rare. In 1956, US dollars were added as eligible assets. Irish government securities were permitted in 1959, but only for external on-lending to the IMF or World Bank (arising from Ireland's accession to the Bretton Woods institutions in 1957). An asset in the CBI's GF was added in 1961. This was a way of adding to the resources of the GF, but would only make a difference to the extent that the GF itself engaged in domestic activity. In 1969, a reserve with the IMF was added. The reserve was Ireland's gold payment to the IMF plus any loans of Irish currency to IMF members: again, an external asset.⁷³⁴

Ireland's central banking currency board system merits brief comparison with the 'old' currency board systems of other important sterling area countries in the 1960s, notably Hong Kong, Malaysia and Singapore. Honohan's finding that Ireland's new central bank operated like the previous formal currency board was mirrored by similar arguments Schenk made about the new central banks in Malaya, Ghana and Nigeria.⁷³⁵ Schwartz and Schenk in separate ways showed how the varied currency board systems of Hong Kong, Malaysia and Singapore then departed significantly from

⁷³³ Gedeon, 'Money supply endogeneity', p112. See Wolf et al, *Currency boards*, pp183-90

⁷³⁴ Moynihan, *Currency*, p488

⁷³⁵ Schenk, 'Monetary institutions'

orthodoxy during 1967-73. In essence, the sterling peg proved not so important for them, after the 1967 devaluation of sterling, and the subsequent stresses created by exchange rate volatility required domestic interventions by the monetary authorities.⁷³⁶

Balino and Enoch argued that the transition from currency board to central bank in Malaysia, Singapore and Ireland were part of a 'normal evolutionary pattern', the two former countries switching into a float, without disruption, from a position of strength, and Ireland undergoing a graduated and smooth exit.⁷³⁷

Ireland's situation was different from the entrepot economies of Hong Kong and Singapore. Its geography and trade orientation towards the UK, labour market linkages and reliance on London's financial market, made the fixed sterling link an obvious choice.⁷³⁸ The UK's share of Ireland's imports and exports is shown in Figure 2.

O'Grada suggested Irish monetary policy was 'not very exciting before the 1970s',⁷³⁹ for Ireland was essentially monetarily dependent on the UK.⁷⁴⁰ Bourke and Kinsella portrayed the Irish financial system as wholly reliant on London during the sterling link years.⁷⁴¹ When the UK imposed exchange controls against the rest of the sterling area in 1972, Ireland alone was exempted.⁷⁴² In short, Ireland in this period was much more closely integrated with the UK than was Estonia with Germany in the 1990s.⁷⁴³

⁷³⁶ Schwartz, 'Currency boards'; Schenk, 'Malaysia'; Schenk, 'The evolution'

⁷³⁷ Balino and Enoch, *Currency board arrangements*, pp26-8, the citation p28

⁷³⁸ Kavanagh, 'Irish macroeconomic performance'

⁷³⁹ O'Grada, *A rocky road*, p55

⁷⁴⁰ O'Grada, *A rocky road*, pp55-67, 230

⁷⁴¹ Bourke and Kinsella, *The financial services revolution*, p54

⁷⁴² Along with the Channel Islands (Schenk, *The decline*, p339)

⁷⁴³ For Estonian metrics, see De Haan, Berger and Van Fraassen, 'How to reduce'

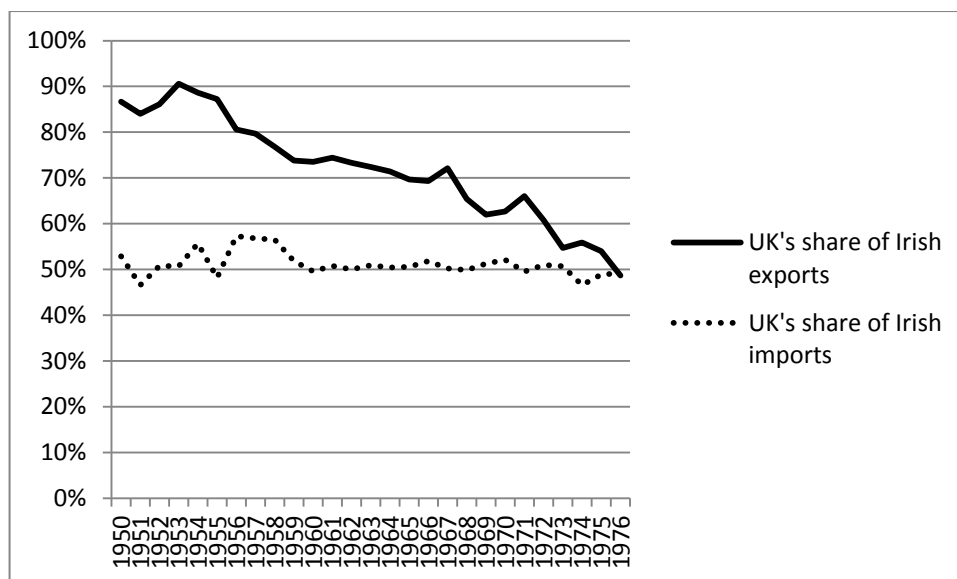


Figure 2: UK's share of Irish merchandise trade, annually during year ended 31 December, 1950 – 1976 (%)

Source: Bielenberg and Ryan, *An economic history of Ireland*, pp129, 134, 139

The accounts of the centralisation and diversification events in the literature have been brief. McGowan regarded the centralisation as important, changing the manner in which bank liquidity had been managed for at least 150 years, and preparing the way for the break with sterling in 1979 – but did not go into details.⁷⁴⁴

The leading account of the diversification was Whitaker's.⁷⁴⁵ According to Whitaker, Irish officials were concerned about sterling's weakness in the years prior to its 1967 devaluation but did not wish to add to sterling's problems by diversifying. After the devaluation, he took the view that sterling's international role was dying and no longer likely to be supported by the UK, and so he negotiated an amicable withdrawal.⁷⁴⁶ From the perspective of currency board theory, however, the resulting currency mismatch, which was achieved before first thoughts about breaking the sterling link,⁷⁴⁷ was unusual.⁷⁴⁸ Currency boards are not supposed to court insolvency by taking such exchange rate risk.⁷⁴⁹

⁷⁴⁴ McGowan, *Money and banking*, p85

⁷⁴⁵ Whitaker, *Interests*, pp127-42

⁷⁴⁶ Whitaker, *Interests*, pp130-1

⁷⁴⁷ Honohan and Murphy, 'Breaking the sterling', p1

⁷⁴⁸ Malaysia and Singapore had currency board elements to their monetary arrangements, and diversified away from sterling in 1967-72, but, unlike Ireland, they did not follow sterling's devaluation in 1967, and

The diversification would have come as a surprise to contemporaries such as Strange, writing in 1968, who described Ireland as economically and monetarily dependent on the UK, seen as 'the one firm anchor-man among the uncertain official holders of sterling balances'.⁷⁵⁰ She alluded further to loyalty, saying that Ireland drew funds from the IMF in 1966 'in preference to drawing down funds from the sterling balances which would have added to British difficulties', and that the offer of a dollar guarantee to Ireland in 1968 as an inducement to keep its sterling balances may have been 'hardly necessary'.⁷⁵¹

A final important aspect of Ireland's tripartite financial system was the power relations between central bank, government and commercial banks, and their counterparts in the UK. In Hong Kong, Schenk's study revealed an intimate, occasionally challenging, relation between the government and powerful note-issuing banks, brought together in the management of the colony's Exchange Fund.⁷⁵² In Malaysia and Singapore, banking was dominated by foreign, particularly British banks. This was not the case in Ireland, given the preponderance of Bank of Ireland and AIB (they accounted for about 90 per cent of the Associated Banks' capital resources, as discussed below). In the 1960s, the Malaysian central bank had limited resources for market operations, but considerable statutory power over the commercial banks' liquidity, lending and interest rates.⁷⁵³ By contrast, until 1969-71, the CBI lacked both resources and statutory powers. O'Grada thought the CBI was dominated by the government, and too gentle on the Associated Banks.⁷⁵⁴ However, central bank insiders were more forgiving.

formally abandoned the sterling peg in 1972 (Schenk, 'Malaysia'). Hong Kong's Exchange Fund retained large amounts of sterling after switching to a dollar peg in 1972, but there were particular reasons for this, and Schenk argued that the Exchange Fund effectively abandoned currency board orthodoxy around this time (Schenk, 'The evolution')

⁷⁴⁹ Hanke, 'Currency boards', pp88, 90

⁷⁵⁰ Strange, *Sterling*, p117

⁷⁵¹ Strange, *Sterling*, p118

⁷⁵² Schenk, 'The evolution'

⁷⁵³ Williams, 'South and East Asia', pp147, 164-6

⁷⁵⁴ O'Grada, *A rocky road*, pp55-67, 230

Meenan said it exercised an important restraining influence on both.⁷⁵⁵ Moynihan and Whitaker testified to its independent, restraining role, albeit with limited tools.⁷⁵⁶

The CBI's board structure reveals the independent power of the Associated Banks. But the government had legislative power, which it had used before (the Central Bank Act 1942) and would use again (the Central Bank Act 1971). Various authors noted that developments around the latter legislation were an important boost to the CBI's (and implicitly the government's) authority over the banks.⁷⁵⁷ Banking was also a nationalist political issue, and the Associated Banks, the CBI and the DF itself were variously accused of being under the sway of their UK counterparts. Taking the period from the 1920s to 1960, Drea emphasised the continuity of strong Anglo-Irish financial relations despite political and trade conflict.⁷⁵⁸ Academic studies have generally found that these relations were not subservient, however. The DF, led by patriots such as Whitaker, responded to the political concerns.⁷⁵⁹ Overall, the writings on these issues suggest balanced relations, between banks and government, between Ireland and the UK. With its painful history of civil war, remembered in the form of Ireland's two leading political parties (Fianna Fáil and Fine Gael), there was a need to get by through consensus.

The data for the paper consists of a descriptive annual run of external reserve data (and other relevant metrics for comparison) from published sources, together with qualitative material from primary archival sources, indicating debates and motivations. Interviews were considered but not pursued. Whitaker was not available and the survivors of these times are very old. The archives consulted were the National Archives of Ireland (NAI), National Library of Ireland (NLI), UCD Archives (UCDA),

⁷⁵⁵ Meenan, *The Irish economy*, pp353-67

⁷⁵⁶ Moynihan, 'The Central Bank', p26; Whitaker, *Interests*, pp177-85

⁷⁵⁷ Chambers, *T.K. Whitaker*, p206; Davy Kelleher McCarthy, *The control*; McGowan, *Money and banking*, pp78-88; Whitaker, 'The changing face', p1

⁷⁵⁸ Drea, 'Bank of England'

⁷⁵⁹ Chambers, *T.K. Whitaker*; Fanning, *Department of Finance*, pp407, 634

Central Bank of Ireland (CBI), Bank of Ireland (BOI), Ulster Bank (RBS), The National Archives of the UK (TNA) and Bank of England Archive (BOE).

The annual run of data on Ireland's official external reserves has been taken from various published sources, due to the changing ownership of the reserves.⁷⁶⁰ Access to Irish primary financial sources for the post-war period is not straightforward. The NAI, NLI and UCDA⁷⁶¹ records have been well-studied by historians, but not through this particular lens. For new qualitative insights, the NAI's files (Department of Finance, Department of the Taoiseach (DT), Department of External Affairs, Cabinet Minutes) were informative. The most important qualitative source was that of the CBI, whose archive was in the course of being opened up to external researchers, and was therefore only partly accessible due to archival preparation. The files viewed revealed the conflicts and priorities of the tripartite organisations in the 1960s. Further access may reveal more. The most difficult sources were those of the Associated Banks. The records of AIB were not available, and only the Court records of BOI were able to be viewed. The larger of the two smaller banks, Ulster Bank, was chosen to deepen the picture. Finally, the TNA and BOE files revealed Anglo-Irish negotiations and British perceptions, especially from the late 1960s.

⁷⁶⁰ Referenced tables in Moynihan, *Currency*, supported by Whitaker, *Interests*, p139; POSB, annual statements of account, for calculating sterling's share of reserves; and CBI, annual statements of account, for reviewing the assets and liabilities of the LTNF and GF

⁷⁶¹ UCDA looks after many of Whitaker's documents

Section 3 The currency board orthodoxy of Ireland's financial system

In order to explain and set the scene for the centralisation and diversification events, this Section uses a mixture of published data and some archival records to examine the currency board orthodoxy of Ireland's financial system. The question of orthodoxy can be considered on three levels. The first level was the LTNF. We saw in the last Section that the LTNF was, clearly, an orthodox currency board, with the only exceptions being the asset in the GF (which, as will be shown, was not large, in the range of £20-30m, and was not a sufficient condition for loss of orthodoxy, which depended on the behaviour of the GF) and its diversification from sterling in the 1970s. The second level was that of the CBI, being the GF and LTNF together. This was the holistic question considered in Honohan's article: he argued that the CBI was behaving like a currency board.⁷⁶² The third level was the tripartite financial system as a whole: did it reflect the expectations of the currency board advocates? After briefly providing further detail in support of Honohan's argument about the CBI's role, the Section focuses mainly on the third, wider level.

Whether the CBI was a de facto currency board depends on three things. Firstly, the relative sizes and resources of the GF and LTNF; secondly, the extent to which the GF was acting like a central bank (investing in domestic assets, acting as LLR); thirdly, the extent to which the LTNF was acting like a currency board (we have argued already that it was).

⁷⁶² Honohan, 'Currency board'

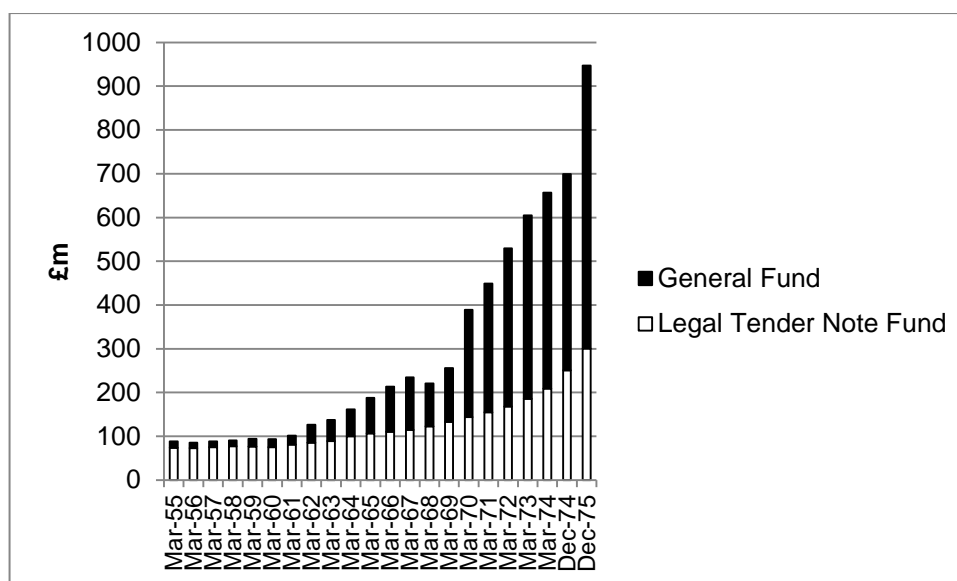


Figure 3: Assets of Legal Tender Note Fund and General Fund, CBI, end-month, March 1955 – December 1975 (£m)

Source: CBI annual statements of account, 1955-75

Although the nominal values in Figure 3 are affected by inflation, particularly in the 1970s, it is clear that by March 1968, the GF, with a balance sheet value of £98m – albeit more resourced than in the 1950s (it did not exceed £20m until 1961) – had not progressed far. It had received some deposits in the 1960s, from the Associated Banks and the government (described later), but the changes in 1968-72 were altogether more significant. If we turn now to the breakdown of the assets of the GF, addressing the changing scale by expressing the categories as percentages of the whole, it is possible to identify the key domestic activity. This breakdown is shown in Figure 4. The GF's domestic central bank activity is captured in the category 'bills rediscounted and Irish government'. Most of the 'short money' (cash, bank balances and money at call) was external, as was the category, 'gold, IMF and other investments'. Not surprisingly, this domestic central bank activity cropped up in the Irish crises of 1955-6 and 1965-6, events which are described further below.

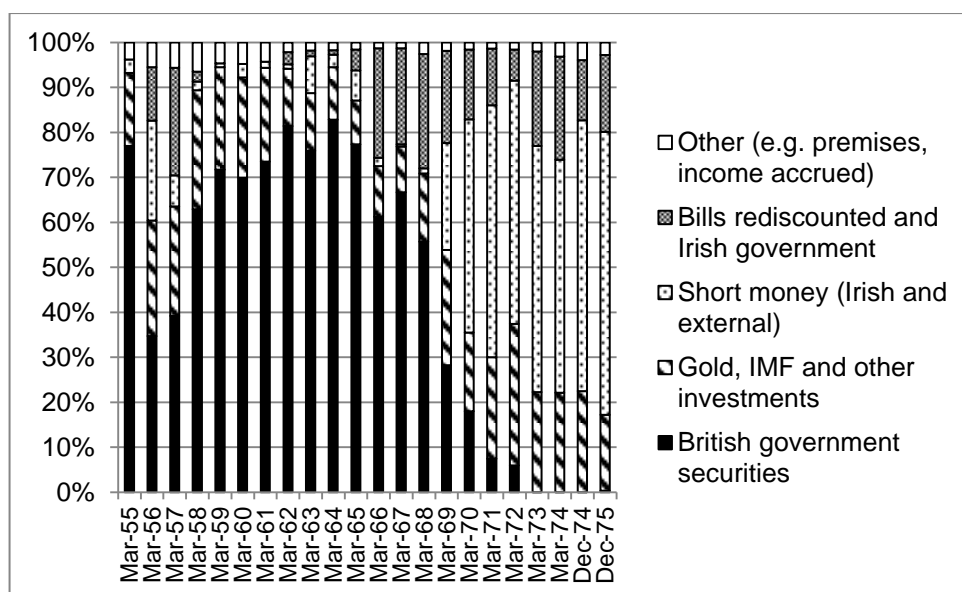


Figure 4: Percentage composition of assets of General Fund, CBI, end-month, March 1955 – December 1975 (%)

Source: CBI annual statements of account, 1955-75

Note: It is not possible to separate all domestic holdings from 'Short money' (e.g. Irish currency) and 'Gold, IMF and other' (other investments included shares in the BIS) but the vast majority of these categories were external holdings, so that 'Bills rediscounted and Irish government' was the principal domestic asset

The same breakdown can be made for the LTNF, see Figure 5. Here, all assets were effectively external other than the 'asset in the General Fund'. As one might expect, the LTNF retained its sterling holdings longer than the GF did, but by December 1974, sterling was less than 40 per cent of the LTNF assets, and by December 1975 less than 20 per cent, an unusual orientation for a currency board given the sterling link, even allowing for a currency board's capacity for unused and illiquid investment holdings. This was before thoughts of breaking the link: indeed, Barry argued that Ireland parted company with sterling in 1979 more for political than economic reasons, and because the UK's late decision not to join the EMS forced Ireland to choose.⁷⁶³ In summary, the GF and LTNF each held a high proportion of external assets, which supports Honohan's conclusion about the currency board approach – the principal unorthodox aspect being the diversification from sterling.

⁷⁶³ Barry, 'Diversifying external linkages'

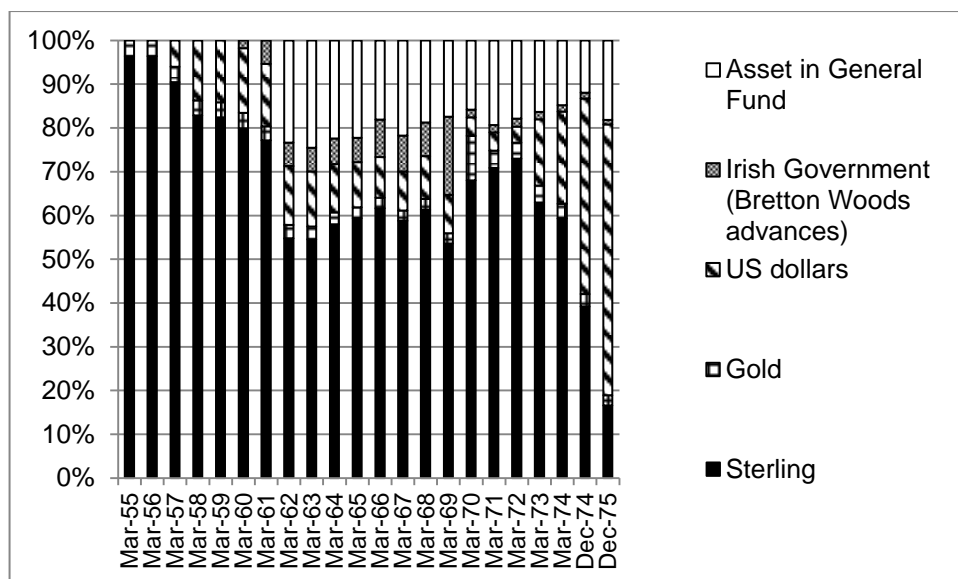


Figure 5: Percentage composition of assets of Legal Tender Note Fund, CBI, end-month, March 1955 – December 1975 (%)

Source: CBI annual statements of account, 1955-75

We turn now to the wider financial system. There were several aspects in which Ireland's financial system did not fit the traditional currency board fact pattern. One was the maturity of its banking system. If we compare the ratio of M2 (which includes savings and term bank deposits) to notes in circulation across other sterling area countries, which either operated or had emerged from currency board systems, its ratio was higher than that of Malaysia, Singapore or Nigeria, and in line with central bank-run New Zealand (see Figure 6).

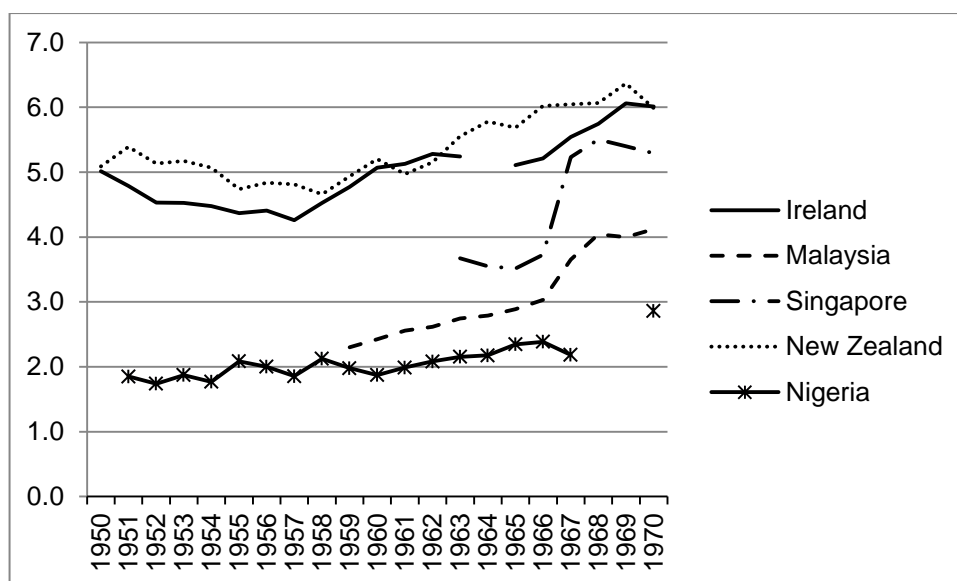


Figure 6: Ratio of M2 to notes in circulation for Ireland and selected sterling area countries, 1950 – 1970 (ratio)

Source: Mitchell, *International Historical Statistics*. For definitions and ultimate sources, see Mitchell

Note: Mitchell's 1964 figure for note circulation in Ireland looks suspect relative to Moynihan, *Currency*, pp512-3 and has been excluded. The 1968-9 data for Nigeria excluded three eastern regions and so have also been excluded

This ratio is important because it has become an area of dispute between currency board advocates and critics. The advocates suggest that it is sufficient for external assets to cover the monetary base, while the latter argue that wider money ought also to be addressed, which makes a currency board too costly when the ratio is high. In the case of Mexico in 1995, the argument was about figures of US\$11 billion and US\$50 billion in foreign reserves being required to set up a currency board, not dissimilar from Ireland's ratio.⁷⁶⁴ Ireland's ratio was also increasing during the 1960s.

What did this mean for Ireland's financial system? It meant that, more than otherwise, the commercial banks, rather than the LTNF, were likely to be the principal absorber of shocks. This can be seen in Figure 7, which compares changes in total official external reserves with changes in the net external assets of the Associated Banks.

⁷⁶⁴ Williamson, *What role*, p36

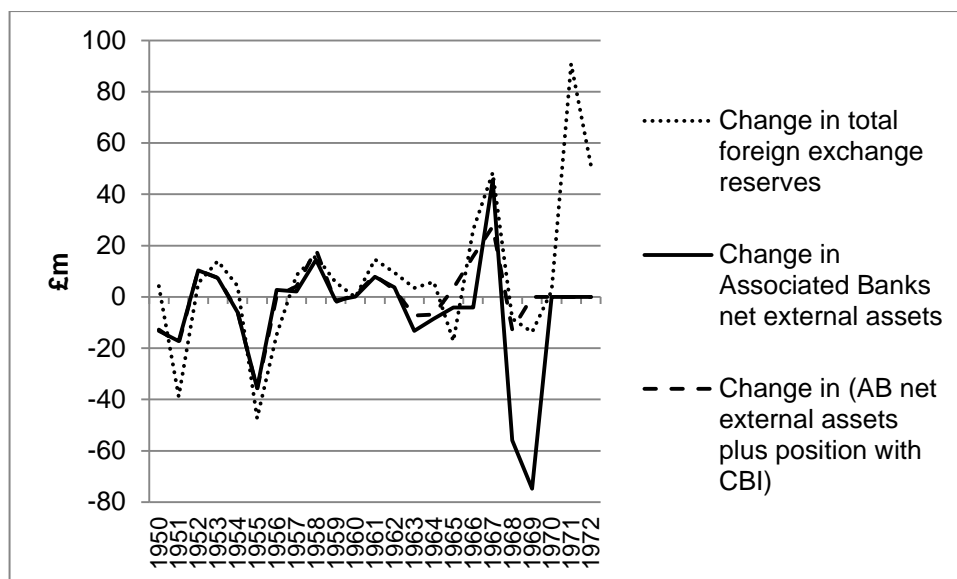


Figure 7: Annual change in Ireland's official external reserves and Associated Banks' net external assets, years to 31 December, 1950 – 1972 (£m)

Source: Calculated from Moynihan, *Currency*, pp530-1

Note: Position with CBI = deposits with CBI less bills rediscounted with CBI; AB = Associated Banks

Figure 7 shows that the Associated Banks' net external assets absorbed much of the variation in Ireland's FX reserves until they were centralised into the CBI in 1968-9.

The dashed line shows the underlying change in the Associated Banks' combined net external assets and net central bank position (their deposits with the CBI less bill rediscounts by the CBI), which might be considered a better reflection of their available reserves position. Due to increasing liquidity pressures on the banks in 1965, the CBI stepped in to assist with financing in that crisis year, as will be discussed, and so absorbed the 1965 downturn in total reserves.

Why were the Associated Banks under liquidity pressure in the mid-late 1960s? This brings us to the second unorthodox aspect of Ireland's financial system, which might not appeal to the currency board advocates, namely domestic credit, and monetary financing of the public sector. The advocates favour currency boards because they help to achieve fiscal discipline: the critics disagree that currency boards alone can instil fiscal discipline.⁷⁶⁵ Williamson called this the 'central question'.⁷⁶⁶

⁷⁶⁵ Hanke, 'Currency boards', p90; Williamson, *What role*, pp40-1

⁷⁶⁶ Williamson, *What role*, p40

Monetary financing of the public sector principally comprises borrowing from domestic banks, borrowing from the central bank, and borrowing from external sources. By 1980, this was becoming a problem in Ireland. Murphy observed that, in that year, 70 per cent of the UK's Public Sector Borrowing Requirement (PSBR) was financed in a non-monetary way, while 'over 75 per cent of the Irish PSBR came through monetary financing',⁷⁶⁷ principally external borrowing. Bradley et al's macroeconomic study of Irish fiscal policy in 1967-80 found that, although 'not very active'⁷⁶⁸ in 1967-71, discretionary fiscal policy across the whole period led to a 'massive deterioration in both the balance of payments and the borrowing requirement',⁷⁶⁹ the inheritance of 'a public authorities deficit of almost 16 per cent of GNP'⁷⁷⁰ in the 1980s, and a 'huge debt which must be repaid in future periods'.⁷⁷¹ While the scale of monetary financing was much less in the 1950s-60s, it was taking place throughout these years, particularly in the form of borrowing from domestic banks.

One can see this financing of government spending taking place in various ways.

Firstly, the government spent most of its Departmental Funds in the 1950s, eventually depositing its remaining sterling (£11m) with the CBI in 1964. The increasing Irish deposits in the POSB were invested in domestic government and other Irish assets.

This is shown in Figure 8.

⁷⁶⁷ Murphy, 'Inflation', pp40-1

⁷⁶⁸ Bradley et al, *Medium-term analysis*, p4

⁷⁶⁹ Bradley et al, *Medium-term analysis*, p5

⁷⁷⁰ Bradley et al, *Medium-term analysis*, p151

⁷⁷¹ Bradley et al, *Medium-term analysis*, p152

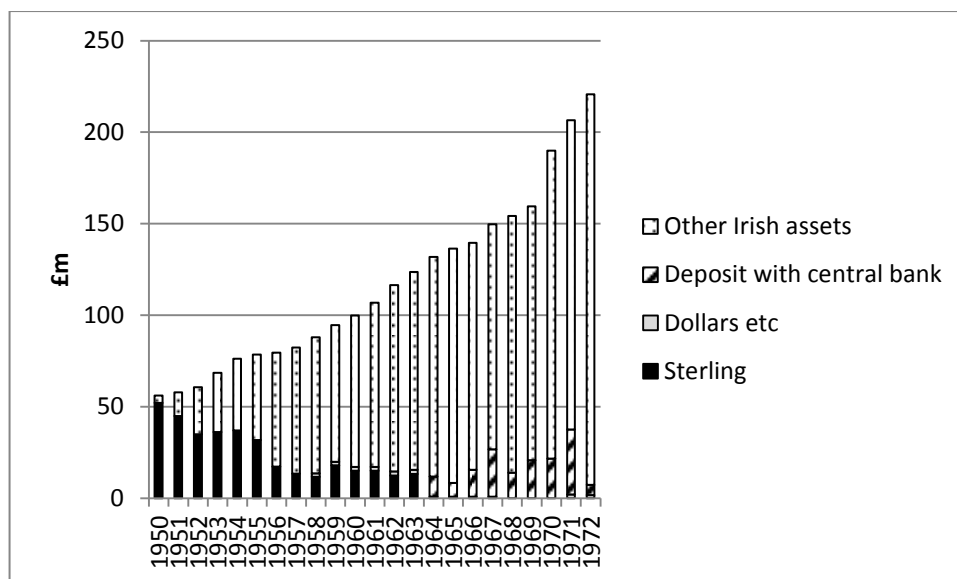


Figure 8: Composition of Irish Post Office Savings Bank (POSB) assets, by currency and type, annually at 31 December, 1950 – 1972 (£m)

Source: POSB statements of account, 1950-72

Then there was Associated Bank lending to the public sector. This took two forms, short-term Exchequer bills, and other investments. The Exchequer bills were not like UK Treasury bills. They were illiquid, since there was no Irish money market, and they tended to be rolled over into new Exchequer bills when they came to maturity. Some Exchequer bills could be rediscounted at the CBI if necessary, in a limited way (as will be discussed). Irish government bonds were also illiquid. The scale and composition of Associated Bank lending is shown in Figure 9. Government investments constituted 10 per cent of all Associated Bank credit at the end of 1964, 20 per cent at end-1966, and 27 per cent at end-1969.

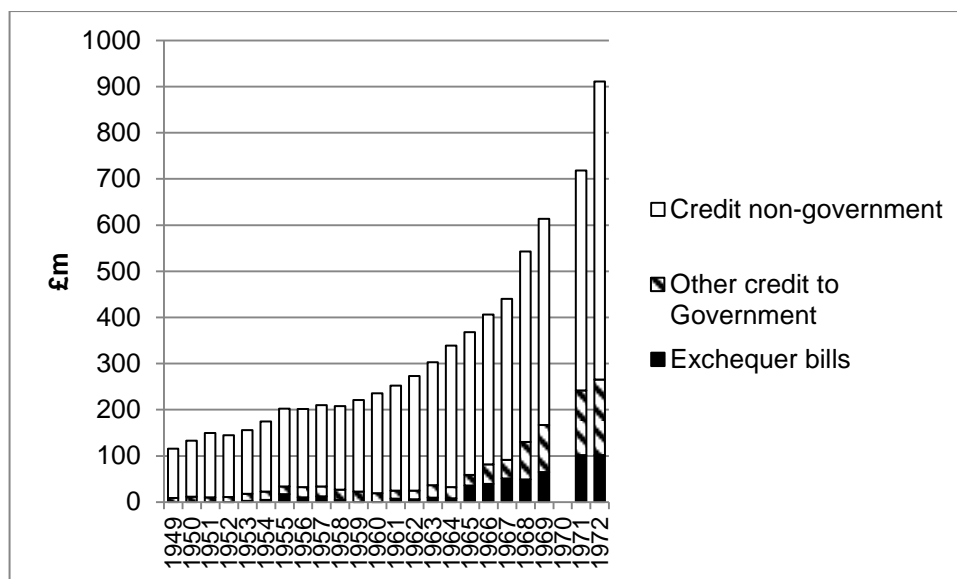


Figure 9: Composition of Associated Bank credit to government and non-government sectors, as at 31 December, 1949 – 1972

Source: Moynihan, *Currency*, pp532-3

Note: No data for 1970 due to bank dispute

Finally, if public sector needs could not be met by the banks, the government could resort to external borrowing. This happened during the crisis of 1965-6. The borrowing programme was prompted by balance-of-payments pressures, the government's capital budget, and the Irish banks' refusal to extend more funds. Details of the programme (a principal sum of £25m) are in Annex 2. It was little short of a disaster. The first, planned, dollar bond issue had to be withdrawn due to lack of demand. Ireland then drew from the IMF. It borrowed expensively through a Deutschemmark bond. There was a curious sterling loan from the Dublin branch of a Canadian bank – it is not clear if the UK authorities were aware of this transaction, since they had been refusing to allow a sterling bond in London – and the same branch later received an Irish pounds deposit from the POSB. Finally a sterling bond issue was permitted under Bank of England sponsorship: it was significantly undersubscribed, 88 per cent apparently being left with the underwriters. A government spokesman concluded that external borrowing was 'difficult and dear',⁷⁷² and Ireland did not return to the external markets until the 1970s, when it borrowed heavily.

⁷⁷² NAI:TSCH/96/6/384, Dáil report, 27/9/1966. Details in Annex 2

A third area of divergence from the currency board ideal was interest rates. Honohan and O'Grada argued that the crisis of 1955-6 was a major interest rate policy blunder, as the Irish government persuaded the Associated Banks not to increase interest rates after a rise in UK rates early in 1955. This resulted in an expansion of domestic credit in Ireland and capital outflows, and capitulation by the government at the end of 1955.⁷⁷³ But although rising UK interest rates were not generally matched fully by Irish rates over this period, the authors argued that subsequent narrowing of the differential at times of high UK rates did not have such drastic effects after 1955. They thought that the Associated Banks could have been simply absorbing narrower differentials, since rising British interest rates were generating higher profits overall, or rationing credit when differentials were under pressure.⁷⁷⁴ A comparison of the UK-Irish interest differential using the CBI's minimum rediscount rate suggested that the 1955-6 period was the most extreme divergence during this period.⁷⁷⁵ In compiling a long-run interest rate time series for Ireland, Gerlach and Stuart even used sterling bill discount rates for 1933-62, arguing the difficulty of establishing an Irish interest rate and that market rates probably diverged from official ones.⁷⁷⁶

Nevertheless, since the Associated Banks set lending rates in Ireland, it is interesting to see how the cartel's ordinary overdraft rate compared with the British rates. The UK Treasury bill rate is not, however, a good comparator, as, in the 1960s, the Bank of England was intervening in an attempt to manage forward exchange rates for sterling, so deposit rates for UK local authorities, finance houses and eurosterling have sometimes been used as a better indicator of British market interest rate conditions. Figure 10 shows interest rates in Ireland (the CBI's minimum rediscount rate, and Associated Banks' large deposit and ordinary overdraft rates) and the UK (3 month Treasury bills and local authority deposit rates) quarterly over the period.

⁷⁷³ Honohan and O'Grada, 'Irish macroeconomic crisis'

⁷⁷⁴ Honohan and O'Grada, 'Irish macroeconomic crisis', pp64-5

⁷⁷⁵ Honohan, 'Currency board', Figure 3, p53

⁷⁷⁶ Gerlach and Stuart, 'Money, interest rates', p14

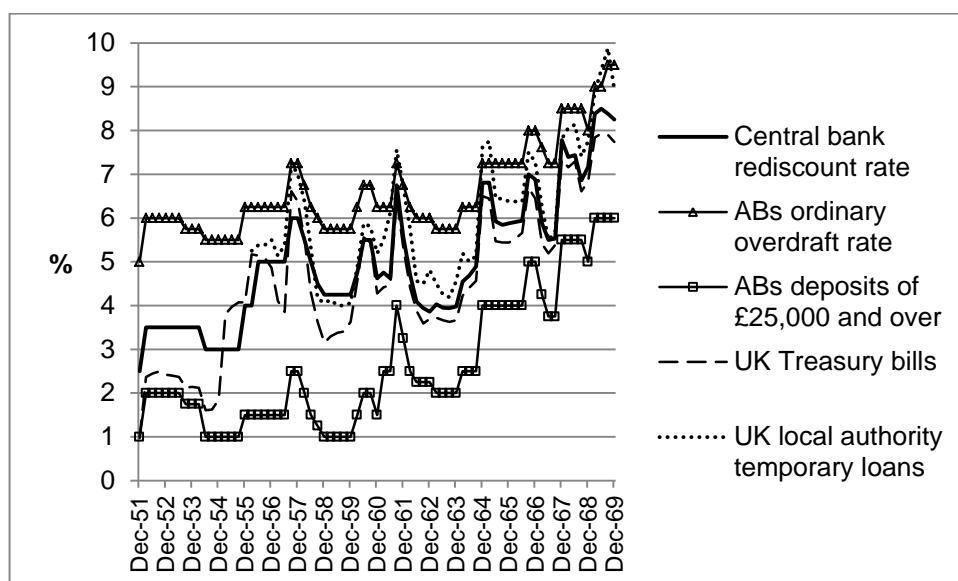


Figure 10: Selected interest rates in the UK and Ireland, quarterly at end of quarter, December 1951 – December 1969 (%)

Source: Moynihan, *Currency*, pp524-7; TNA:T267/29, 'Sterling balances', pp109-23

Note: ABs = Associated Banks. Local authority 'temporary loans' is a deposit rate. The British figures are 3 month rates

Figure 10 indicates a narrowing in the 1960s of the (wide) margin between the Associated Banks' deposit and overdraft rates, and this probably reflected competitive pressure from the non-Associated Banks, which were not governed by the cartel rates and were expanding rapidly during this period. To see more clearly the effects on Ireland of rising UK interest rates, Figure 11 shows two differentials. The first differential, between the CBI's minimum rediscount rate and the UK Treasury bill rate, mirrors the picture in Honohan's article,⁷⁷⁷ and gives the impression that relative orthodoxy was established in the 1960s. But the second differential, between the Associated Banks' overdraft rate and UK local authority deposit rates, continued to fluctuate in the 1960s. In 1961 and 1965 and 1969 (when UK rates were pushed up due to pressure on sterling) there was even a technical arbitrage (negative differential) based on these rates. The second differential is the more realistic picture, and accords

⁷⁷⁷ Honohan, 'Currency board', p53

with Meenan's admission that interest rate changes were heavily negotiated with government, which 'leaned in favour of low rates'.⁷⁷⁸

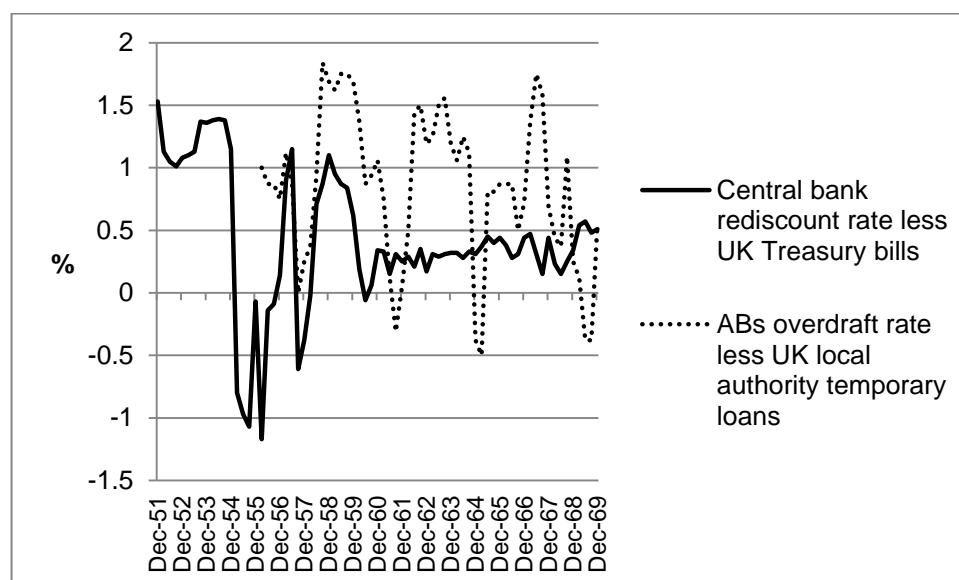


Figure 11: Selected Ireland-UK interest rate differentials, quarterly as at end of quarter, December 1951 – December 1969 (%)

Source: calculated from underlying data in Figure 10

Note: ABs = Associated Banks

The fourth area of Irish divergence might *not* be considered as a violation of currency board principles by currency board advocates. This was the CBI acting as a lender to the commercial banks or government at times of stress, which was notable in 1955-6 and 1965-6. Jao argued that LLR activity in Hong Kong in the 1980s was orthodox because it came not out of the Exchange Fund itself but from the colony's fiscal funds.⁷⁷⁹ Similarly the CBI's GF, not the LTNF, was the source of lending support in Ireland. Also, the amounts were not large, as discussed below. This was not conventional bill rediscounting or LLR activity, however. The CBI was in effect stepping in, when the Associated Banks were resisting the government's regular request for credit. The CBI was thus acting as a lender of second resort, rather than last resort.

⁷⁷⁸ Meenan, *The Irish economy*, p356

⁷⁷⁹ Jao, 'The working', p235

Balino and Enoch wrote that the Irish banks ‘resorted to banks in London for liquidity support’,⁷⁸⁰ a claim that is sometimes seen in the literature, but I could find no evidence (for instance, in the Bank of Ireland Court records) to support it, nor any rationale for it (in 1939, the Bank of England explicitly made clear that it would not support Irish banks).⁷⁸¹ Obviously the two smaller UK-owned Associated Banks enjoyed parental support. Irish banks had UK banking contacts which acted as ‘London agents’ for them, but these were agents, not principals. Balino and Enoch cited Honohan as the source for their statement, but in fact Honohan said something different: that the Irish banking system, with its large net external assets, had no need of a central bank to act as LLR – and he was only referring to the position in 1943.⁷⁸²

Honohan suggested that the CBI’s first bill rediscounting was a market reaction to the policy blunder of low Irish interest rates: he said it was no surprise that 1955-6 ‘saw the first use of the rediscount facility, with bills both of a state-owned enterprise and of the Exchequer being refinanced at rates considerably more favourable than obtainable in London’.⁷⁸³ However, my impression is that the recourse to bill rediscounting was based on perception of need, rather than market opportunism. These Irish bills had no market, the banks were concerned by the loss of external liquidity,⁷⁸⁴ and Moynihan’s CBI history revealed that the first Exchequer bill rediscounting (in January 1956) arose to resolve a £7.5m gap between what the Irish Exchequer wanted and the Associated Banks were prepared to provide. Moreover, it took place *after* the increase in the published rediscount rate from 3 per cent to 4 per cent on 19 December 1955.⁷⁸⁵ From 1956 to 1961, there was a CBI understanding with the banks that bill rediscounting would only be made in case of need, up to an aggregate limit of £9-10m

⁷⁸⁰ Balino and Enoch, *Currency board arrangements*, p27

⁷⁸¹ Drea, ‘Bank of England’, p73

⁷⁸² Honohan, ‘Currency board’, p47

⁷⁸³ Honohan, ‘Currency board’, p53

⁷⁸⁴ McGowan, *Money and banking*, p80

⁷⁸⁵ Moynihan, *Currency*, pp425-6

outstanding.⁷⁸⁶ The GF, with total assets of only £12.5m in March 1956, did not have such liquid sterling resources at its command. It was this need for sterling in the GF, and not a particular desire to diversify from sterling, that prompted the CBI to make US dollars eligible investments for the sterling-rich LTNF in August 1956. The GF already held dollars, and more dollars could be acquired from Irish citizens' legacies and remittances from the USA. By March 1958, the LTNF had accumulated £10.5m of dollar investments, but there was little momentum for change thereafter: its dollar holdings remained in a range of £10-12m until 1969.⁷⁸⁷

CBI support was a similar story in 1965-6. Although, until 1972, the government at least aimed at current fiscal balance, the 1965-6⁷⁸⁸ capital budget, part of the government's 1964-70 Second Programme for Economic Expansion, focused on schools and hospitals, was then running at around £100m per annum (about 10 per cent of GNP), nearly half of which would need to be funded from the banking system and the aforementioned external borrowing programme. The Associated Banks, concerned about their liquidity position, which came close to breaching new CBI guidance in this year (of which more in the next Section), refused to provide new funding in September 1965. In response, the CBI gave £20m of special assistance to the government, taking up a new 6 per cent four year National Loan indirectly via the banks.⁷⁸⁹ Meenan wrote that Ireland's public finances were 'in disorder' in 1965-6.⁷⁹⁰

This Section has shown that Ireland's currency board, the LTNF, was not necessarily the most important part of its financial system, which hinged on the relationship between the government and the Associated Banks. If Ireland could run a fiscal deficit of around 10 per cent of GNP in the mid-1960s, half through monetary financing, how

⁷⁸⁶ Moynihan, *Currency*, pp431, 454-5. These limits were relaxed somewhat after 1961

⁷⁸⁷ Moynihan, *Currency*, pp435-6. The GF had already taken powers to buy dollars in 1953 (\$1m per year from the sale of dollar securities in Irish ownership) and held £1.2m of dollars in Aug/1956 (pp417, 436)

⁷⁸⁸ The Irish fiscal year was April-April

⁷⁸⁹ NAI:TSCH/96/6/384, '6 per cent Funding Loan, 1969', MfF, 17/1/1966

⁷⁹⁰ Meenan, *The Irish economy*, p381

much fiscal discipline was the currency board itself imposing? The key issue was that the CBI was often not consulted on decisions or discussions, or its advice not heeded. This led to the resignation of its first Governor, Brennan, in 1953.⁷⁹¹ Meenan suggested that the CBI was not consulted about the Second Programme in 1963-4.⁷⁹² The archival record indicates that the CBI Governor was not even consulted in the days and hours before the Cabinet's decision to maintain parity with sterling when the latter devalued in 1967.⁷⁹³

One should not exaggerate these divergences from the currency board advocates' ideal. Whether through Associated Banks resistance, lack of appetite internationally for Ireland's bond issues, or conservative advice from Whitaker at the DF, and ultimately the effect on reserves of the fixed exchange rate policy, market disciplines were being felt by the Irish government during this period. It meant that the Second Programme had to be abandoned early, and replaced with a Third Programme. There was confidence in the sterling link, and fear that the Irish pound would be devalued if the link were broken.⁷⁹⁴ When, in August 1965, the Taoiseach, Lemass, wrote to the Minister for Finance asking if Ireland should abandon the sterling parity and float the Irish pound, the firm advice he received was no.⁷⁹⁵ The issue is whether the discipline was being imposed by the fixed exchange rate policy, or by the currency board mechanism: there was no 1960s non-currency board counterfactual with which to compare the situation. But the longer-term principles of monetary financing, interest rate management, and central bank lending were present, and it did not seem to take much adverse change to bring them into play. The Irish tripartite financial system involved a continuous credit dialogue and relationship between the banking cartel and

⁷⁹¹ O'Broin, *No man's man*, pp163-4

⁷⁹² Meenan, *The Irish economy*, p364

⁷⁹³ CBI:FO611123,34/65, 'Devaluation of sterling...', Moynihan, 21/11/1967; Ministers confirmed the policy on 14/11/1967, NAI:TSCH/99/1/191, 'Pound sterling, devaluation', 14/11/1967

⁷⁹⁴ McGowan, *Money and banking*, p86

⁷⁹⁵ NAI:TSCH/96/6/293, Lemass-Lynch correspondence, 5/8-15/10/1965. In its Apr/1965 report, the CBI rejected independent devaluation of the Irish pound, on the grounds that increased import prices would soon affect costs (CBI:FO611123,34/65, 'Effects of currency devaluation')

the Irish government, with the CBI often, but not always, acting as interlocutor. In the next Section, it will be shown how these conditions led to the centralisation of the Associated Banks' net external assets in 1968-9.

Centralisation of the banks' sterling reserves was not a new issue. There had been nationalist criticism of the banks' sterling holdings since the 1920s,⁷⁹⁶ typically expressed as the need to 'repatriate' the sterling in order to invest it in the Irish state. The banks held sterling for liquidity reasons. The CBI's Report of the Money Market Committee (MMC), published in 1969, found that the Associated Banks' government securities investments in June 1968 were indeed disproportionately in the UK,⁷⁹⁷ but also noted that turnover in the Irish gilt market was less than one per cent that of the British gilt market, and that the £75m of Irish Exchequer bills then outstanding were largely held by the banks themselves and had no liquidity.⁷⁹⁸ In order to understand the 1968-9 timing of the centralisation, it is necessary to appreciate the earlier debates as well as the particular circumstances of those years.

4.1 Slow progress in the 1950s

Whitaker himself had a nuanced position about these sterling assets. He was critical of them, and of the lack of CBI initiative towards full exercise of its functions in the 1950s,⁷⁹⁹ but he thought new legislation was politically risky, and wanted unanimous decisions from the CBI's board in order to allay concerns: 'functions must be exercised if they are not to become atrophied'.⁸⁰⁰ This 'policy atrophy' problem mirrors Kopcke's aforementioned critique of currency boards.⁸⁰¹

⁷⁹⁶ McGowan, *Money and banking*, p80

⁷⁹⁷ A rebalancing to match the Associated Banks' current and deposit account liabilities within and outside the state would have required a transfer of £113m from British to Irish gilts (CBI:MMC Report)

⁷⁹⁸ CBI:MMC Report. Meenan said the banks were by then under liquidity pressure, due to the resource demands of the state (Meenan, *The Irish economy*, pp353-67)

⁷⁹⁹ CBI:F1588747,36/61, Whitaker to MfF, 29/3/1955, accompanying 'Desirable banking reforms'; CBI:F1588747,36/61, 'Stages in the evolution...', Whitaker, Jul/1960

⁸⁰⁰ CBI:F1588747,36/61, 'Stages in the evolution...', Whitaker, Jul/1960

⁸⁰¹ Kopcke, 'Currency boards'

In 1957, after the 1955-6 crisis, there were external appeals for a strong central bank directing monetary policy.⁸⁰² One academic paper, passed to Whitaker by the Minister for Finance, called for centralisation of all net external assets within the CBI, which should also take over the government's account from BOI, start to pay interest on deposits, abolish the LTNF and the automatic link between Irish notes and sterling, and so take control of credit policy.⁸⁰³ Whitaker corresponded with three leading economists who wanted to see central control of external assets because they regarded the banks' holdings as too vulnerable, to adverse movements in trade, credit creation, and confidence in the sterling parity and the banking system. Whitaker replied that it was a question of priorities and timing: better to solve the fundamental problem of productive investment first and work with the current financial system, than to reform the financial system before the investment problem had been solved.⁸⁰⁴

Whitaker did act quickly, however, in July 1957, after receiving a more cautious paper, 'The powers of the central bank', written by CH Murray, then of the DT,⁸⁰⁵ at the Taoiseach's request. The paper was balanced about the practicalities of transferring the banks' net external reserves, but prioritised a role for the CBI in clearing inter-bank liabilities, taking on the government's account, and introducing a fiduciary element to the note issue. Murray's view was that the CBI should only take on responsibilities such as acting as LLR if it were given the resources and powers to do so.⁸⁰⁶ Whitaker urged the CBI Governor, McElligott, to proceed with the central clearing idea, one which they had discussed before,⁸⁰⁷ which would involve paying interest on clearance deposits (the Central Bank Act 1942 generally precluded payment of interest by the CBI). The difficulty of implementing change is evidenced by the fact that it was not until

⁸⁰² e.g., a speech by Pakenham addressing National Bank shareholders (NAI:TSCH/S15438 B, 'Irish banks and the payments deficit', *The Banker*, Mar/1957)

⁸⁰³ NAI:TSCH/S15438 B, and UCDA:P175/46, 'An amended Irish monetary system', Gibson, 17/5/1957

⁸⁰⁴ NAI:TSCH/S15438 B, and UCDA:P175/47, Correspondence, Whitaker with Carter, Lynch, Ryan, May-Aug/1957

⁸⁰⁵ CH Murray subsequently joined the DF, and succeeded Whitaker in 1969

⁸⁰⁶ NAI:TSCH/S15438 B, UCDA:P175/47

⁸⁰⁷ UCDA:P175/47, Whitaker to McElligott, 24/7/1957

November 1958, after much tripartite negotiation, that the CBI began to participate in central clearing.⁸⁰⁸

4.2 Conflict at the CBI's board and with the banks, 1961-4

After Moynihan⁸⁰⁹ replaced the conservative McElligott as Governor of the CBI in 1961, the CBI's staff made proposals for banking system reform. The central bank's economist, Oslizlok, authored a memorandum on central banking powers which impressed Whitaker.⁸¹⁰ After consultation between the two, this was circulated at the CBI board meeting on 26 October 1961.⁸¹¹ By then, the 'asset in the General Fund', creating a quasi-fiduciary element within the LTNF, had already been introduced, in August 1961 (the timing of this coinciding with another sterling crisis).

Oslizlok's memorandum was based on seven characteristic functions of a central bank. The central bank should regulate the currency; act as banker and agent to the government; be a depositary for banks; manage international reserves; act as LLR for banks; settle inter-bank clearances; and control credit. Major recommendations were to transfer assets from the LTNF to the GF, and for the CBI to take on the customary government and bank depositary roles.

There were strong reactions at the board. McElligott warned against 'totalitarianism' on the part of the state's central bank; Glenavy, the banking director from BOI, whose government account role was under threat, called it an 'amputation'. There were five parts to the memorandum, and in subsequent board meetings, Moynihan tried to steer the board to an agreed statement on each part. By 3 January 1962, there were agreed

⁸⁰⁸ UCDA:P175/47,P175/49, Whitaker-CBI correspondence, Jul-Dec/1957; CBI:F0701147,81/78PT1, CBI-IBSC correspondence/meetings, Dec/1957-Nov/1958

⁸⁰⁹ Moynihan had formerly been DT Secretary and supported CH Murray's 1957 paper

⁸¹⁰ CBI:F1588741,36/61PT1, Whitaker to Moynihan, 27/3/1961

⁸¹¹ CBI:F1588741,36/61PT2, 'Functions and activities...', 16/10/1961

minutes about parts 1 and 2 (relating to general principles and the external assets). Ensuring parity with sterling remained the CBI's 'most essential' function, but in a nod to the memorandum, it was agreed that the external assets served not only note redemption but the 'general needs of the economy', and the CBI's role included influencing 'factors determining the total liquidity position of the economy'. However, after the board meeting on 10 January, a further minute was issued stressing the need to retain adequate external assets in the LTNF to meet its traditional convertibility and other Currency Commission functions.⁸¹² These contradictory minutes indicate a board that was not in unity.

Part 3 of the memorandum related to the CBI's functions with respect to the government. Here board discussion began in earnest at the meeting on 10 January 1962. Despite all Moynihan's attempts to find a modified form of words acceptable to Whitaker and Glenavy, and despite correspondence and meetings over each of the following months, no agreement was reached. Whitaker was in no particular hurry to transfer the Exchequer account, but he did not want to abandon the principle he was demanding that the CBI should be able to provide credit direct to the government and be entitled to act as its fiscal agent. The focus turned to other matters such as the practice of commercial bank lending to the government and the transfer of the remaining external assets of the Departmental Funds to the CBI. By 10 July 1962, Moynihan informed Whitaker that 'further consideration of Part 3... has been postponed and the item has been dropped from the agenda'.⁸¹³ Moynihan did not abandon the transfer of the government account, and held another informal meeting with the Governor and Deputy Governor of BOI, and Whitaker, on 11 March 1963, but the two sides could only agree to disagree.⁸¹⁴ Transfers of government functions were limited to matters such as the CBI agreeing, in July 1964, to take on the performance

⁸¹² CBI:F1588741,36/61PT2, 'Functions and activities...', Moynihan to CBI Secretary, 4/1/1962 and 11/1/1962

⁸¹³ CBI:F1588746,36/61PT3, various

⁸¹⁴ CBI:F1588742, Note, Moynihan, 12/3/1963

of exchange control,⁸¹⁵ and discussions with the DF about the merits of possible new legislation conferring bank licensing powers on the CBI.⁸¹⁶

Part 4 of the memorandum concerned bank deposits at the CBI. It was decided to introduce a new Central Bank Act in 1964 permitting the payment of interest on general deposits as well as clearing balances (on which interest had been offered, at Whitaker's urging, at 0.125 per cent below the UK Treasury bill rate since 1960). A CBI board meeting on 24 April 1963 asked Moynihan and Whitaker to consult with the cartel about the banks holding substantially larger balances with the CBI.⁸¹⁷ Moynihan wrote to the IBSC Chairman (BOI's Governor) on 22 July setting out the board's views. In the first six months of that year, banks' clearing balances at the CBI had averaged less than £5m and the board was envisaging that the amount should be voluntarily raised to £20m.⁸¹⁸ It took time, but this eventually was achieved: by end-1964, Associated Bank total balances with the CBI had reached £19.4m (compared with net external assets of £93.4m).⁸¹⁹

Thus, while some progress was made, the above debates in 1961-4 demonstrated the difficulty of making progress, on a voluntary basis, with the evolution of the Irish financial system. The ideas for developing the CBI's role had long been present, but the basis of agreement was not.

4.3 The Associated Banks' worsening liquidity problem

Part 5 of the Oslizlok memorandum concerned liquidity and acting as LLR, which was becoming a more important issue. With the growth in the Irish economy, the

⁸¹⁵ CBI:F1588742, 'Exchange control', 11/7/1964

⁸¹⁶ CBI:F1588742, 'Minute no.7...', 'Banking: proposed legislation', Moynihan, 21/1/1964

⁸¹⁷ CBI:F1588742, 'Extract from minutes...', 24/4/1963

⁸¹⁸ CBI:F1588742, Moynihan to Crichton, 22/7/1963

⁸¹⁹ Moynihan, *Currency*, p531

Associated Banks faced a looming liquidity problem. In the crisis year of 1955, Associated Bank net external assets declined by 30 per cent, demonstrating their vulnerability to balance-of-payments deficits. At end-1955, the assets stood at around 30 per cent of the banks' current and deposit accounts, and the CBI used this figure as a prudential yardstick for commentary in the following years.⁸²⁰ From 1965, the CBI began to issue credit guidance to the banks and advised a minimum 'central bank ratio' of 20 per cent or more, for the Associated Banks as a whole.⁸²¹ The central bank ratio was now defined as net external assets plus deposits at the central bank less any rediscounts of Exchequer bills with the CBI, all expressed as a ratio of domestic current and deposit accounts.⁸²² The banks came close to breaching this ratio in 1965; at end-1968, the ratio stood at only 20.4 per cent.⁸²³ Liquidity was to undergo further pressure in 1969, as will be discussed.

The problem was that the net external assets of the Associated Banks had a dual role: they were both a front line buffer for international flows and a backing for the banks' current and deposit accounts at a time of credit expansion. The looming concern is shown in Figure 12, in which their net external assets are graphed against two relevant reserve benchmarks (three months of imports and 20 per cent of bank deposits). Deposits with the CBI, the only other form of liquidity available, are also shown: the increase from £22m to £40m in 1966 was a technical issue due to the CBI's crisis action, and reversed in 1967, so the normal deposits at the CBI remained modest at around £20m. The values in Figure 12 do not reflect the centralisation which began in November 1968.

⁸²⁰ Moynihan, *Currency*, p474

⁸²¹ Meenan, *The Irish economy*, p354

⁸²² Moynihan, *Currency*, p474

⁸²³ Moynihan, *Currency*, p531

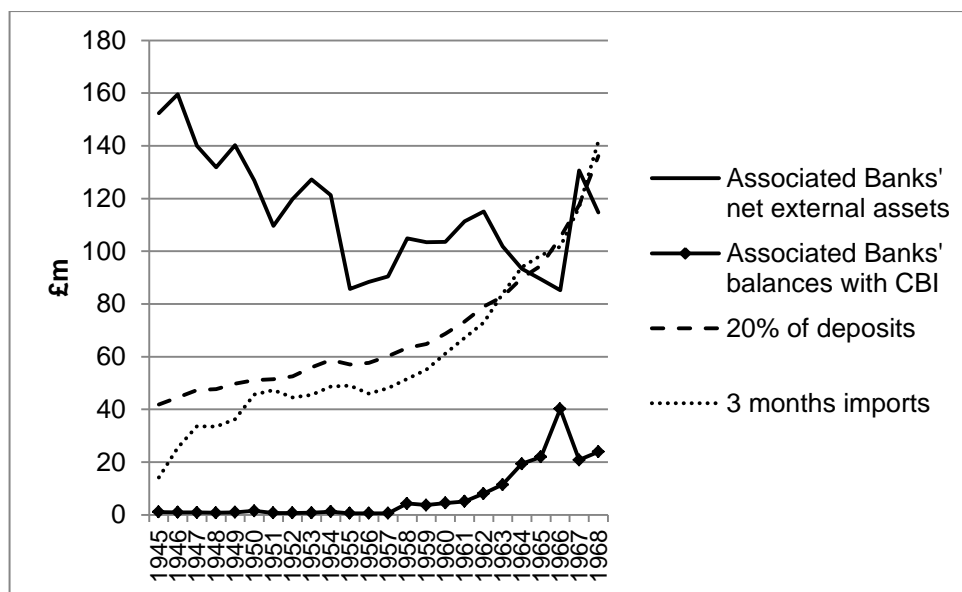


Figure 12: Associated Banks' net external assets, balances with the CBI, and 20 per cent of current and deposit accounts; and three months Irish imports, annually as at 31 December, 1945 – 1968 (£m)

Source: Moynihan, *Currency*, pp530-1; Irish imports from Eurostat, average of preceding and succeeding year divided by four and converted to Irish pounds at £1 = Euro1.265

The records of BOI and Ulster Bank also illustrate liquidity stresses and exposure to illiquid Exchequer bills. Whitaker as Secretary of the DF wrote to Bank of Ireland on 3 March 1967 informing it that, of £40.8m Exchequer bills held by it and maturing at the end of the month, only £5.8m would be repaid at that time.⁸²⁴ In July 1967, internal procedures for selling British gilts were eased.⁸²⁵ Ulster Bank (where the records available to be viewed were more extensive) reported its 'liquidity' to the board in the form of four items, UK Treasury bills (£), Irish Exchequer bills (£), deposits with its British parent Westminster Bank (£), and deposits with the CBI (£). As shown in Annex 1, its illiquid Exchequer bill holdings underwent sticky secular growth over the 1960s, while its liquid UK Treasury bill holdings were reduced to zero by 1964. Its true liquidity consisted of seasonally fluctuating deposits with its parent Westminster Bank and deposits with the CBI.⁸²⁶ Ulster Bank's internal prudential benchmark was the gross lending ratio (gross lending advances as a percentage of deposits) which should

⁸²⁴ BOI: Court minutes, 9/3/1967

⁸²⁵ BOI: Court minutes, 20/7/1967

⁸²⁶ See graphs in Annex 1

not exceed 60 per cent. By July 1969, this measure stood at an 'all-time high' (61.9 per cent).⁸²⁷

4.4 Plans for a Dublin money market

For the banks, a liquid domestic market was thought to be needed before they would consider abandoning sterling. This had been discussed inconclusively at the CBI board in December 1964. In 1966, Moynihan had talks with Bank of Ireland about its new merchant bank subsidiary, which planned to deal in bills, and with merchant bank Guinness Mahon about a possible Dublin discount house, and in November 1966, money markets in Canada and South Africa were reviewed at the CBI's board. Moynihan had constructive discussions about the topic with DSA Carroll, BOI's Governor, in January 1967. On 8 March, the latter handed Moynihan a draft memorandum, 'Banking and the further development of the Irish economy'. The memorandum indicated that Bank of Ireland was taking this topic very seriously.

The paper started with an observation that the tripartite financial system had been characterised by uneasy relationships and confrontations and an 'absence of common ground'. It summarised the aims of the three parties. The government wanted maximum growth consistent with 'preservation of the net external assets of the banking system'. The banks were each concerned with liquidity, not net external assets, and were worried about public demands for credit greater than bank resources, and a central bank reluctant to extend yet further its liquidity support to the banks. The CBI was concerned with inflation and credit, and was treating private credit as a residual to be controlled after the government's needs had been filled. A liquid money market

⁸²⁷ RBS:ULS/443/3, 'Comments... 15th July, 1969'

could resolve the objectives of the parties, and new discount houses could help to create a money market. It called for a working party to examine the issue.⁸²⁸

After consulting with Whitaker and the Bank of England, Carroll returned with the General Manager of the AIB, and held another meeting with Moynihan in April 1967.⁸²⁹ From these beginnings the CBI's Money Market Committee, with tripartite representation, was initiated in May 1967. The joint ownership of the Associated Banks in this project is shown by the fact that the Secretary of the IBSC was one of the two Secretaries to the Committee. It is clear that the primary initiative for the Committee was Carroll's.⁸³⁰ The MMC Report in October 1968, published in April 1969, was important in building confidence and support among banks for placing liquidity domestically, an essential step in accepting the repatriation of their sterling assets.

The CBI was the least enthusiastic of the tripartite organisations about the Report, which highlighted a complete lack of domestic liquidity, and recommended that the CBI support simultaneous development of new money market institutions and changes in the operation and liquidity of the Exchequer bill and Irish government bond markets. For Moynihan and Oslizlok, such recommendations might have suited the government's borrowing requirements and the banks' liquidity needs; but they were placing too great a burden on the CBI without granting it the resources and discretion required of a central bank. Implicitly this risked the Irish currency's external parity, which was the CBI's core mission.⁸³¹

⁸²⁸ CBI:F0609233, 'Banking...'

⁸²⁹ CBI:F0609233,32/67, Note, Moynihan, 14/4/1967

⁸³⁰ CBI:F0609233,32/67, 'Conversation...DSA Carroll', 'Money market', Moynihan, 14/4/1967

⁸³¹ CBI:MMC Report, 2/10/1968, Reservation by Oslizlok; CBI:F0609232, MMC Report, 'Governor's rough notes...', 19/2/1969

4.5 The UK's exchange guarantee and the 1968-9 centralisation

The British offer, in June 1968, of an exchange guarantee for the CBI's sterling holdings was the catalyst for change. This emerged as follows. The Anglo-Irish diversification negotiations of March-May 1968 (see the next Section), which followed sterling's devaluation in 1967, led Whitaker to discuss openly the possible advantages of bringing the Associated Banks' sterling assets into the CBI. Then, in June, to stabilise the sterling area, the UK announced a dollar exchange guarantee for official holdings of sterling in the sterling area, in return for a commitment on the part of those countries to hold a Minimum Sterling Proportion (MSP) of their reserves in sterling, to be negotiated bilaterally.⁸³² At the negotiation meeting with the British on 31 July, Whitaker alluded to the possibility of centralisation, since the British refused to accept that the Associated Banks' net external assets were 'official' reserves covered by the guarantee.⁸³³

In Hong Kong, the banks were themselves offered an exchange guarantee by the Hong Kong authorities.⁸³⁴ But the CBI's GF was hardly in a strong enough position to offer the same to the Associated Banks, which after all had been resisting centralisation – given the sterling link, the Irish pound was unlikely to be revalued against sterling anyway. At a meeting with the British on 21 August, Whitaker's assistant SF Murray reported that the Associated Banks were only prepared to transfer £40m to the CBI, representing the shorter part of their gilt portfolio. Moreover the transfer was problematic, being conditional on 'a substantial and complicated quid pro quo (in the form of an imaginary portfolio of Irish securities which would replace the

⁸³² Schenk, *The decline*, pp273-313

⁸³³ NAI:FIN/2002/19/530, Report of meeting, 31/7/1968

⁸³⁴ Schenk, 'The evolution'

gilt-edged sold to the Central Bank and which could continue to be traded in at London market prices)'.⁸³⁵

The CBI's negotiations were conducted during September with DSA Carroll as Chairman of the IBSC. In the end, a simple, albeit artificial, solution was reached for this £40m tranche, similar in some ways to Hong Kong, under which the banks continued to hold their British gilts, but each bank opened an Irish pound deposit with the CBI, which held a matching sterling deposit with each bank. There was no mention of exchange guarantees for the banks. Politically, it would have been hard for the Associated Banks to refuse the CBI's request completely, given that their sterling holdings were 'official external reserves' in Ireland, and an exchange guarantee for centralised holdings was on offer from the British. It is notable too that Bank of Ireland underwrote the whole transfer, with a £40m exchange with the CBI on 15 November 1968, prior to the final agreement of the Associated Banks. The division of the £40m among the banks was confirmed on 25 November. The division was made pro rata to each bank's capital resources, so the BOI group shouldered 49 per cent, the AIB group 42 per cent, Ulster Bank 6 per cent and Northern Bank 3 per cent of the total £40m.⁸³⁶

Similarly, the wholesale transfer of the remaining Associated Bank net external assets in August 1969 was a reaction to events rather than the result of long-term planning. Whitaker had moved to head the CBI in February 1969. A CBI paper circulated at the board on 9 May reviewed credit proposals for the 1969-70 year. A difficult year was in prospect for the Associated Banks, with net external assets expected to decline from £105m (a total figure which did not reflect the £40m transfer arrangement) to £80m due to the balance of payments. The long-term aim, the paper stated, was for all net external assets to be repatriated, but for the year in question the proposal was that the

⁸³⁵ TNA:T312/1932, 'The Basle scheme...Ireland', BOE, 26/8/1968

⁸³⁶ CBI:F0610949,122/68, CBI-IBSC correspondence Sep-Nov/1968

Associated Banks be asked to transfer a further £15m from British gilts into Irish investments, reducing the net external assets to £65m by the end of the year.⁸³⁷

On 14 May, Whitaker wrote to CH Murray, his replacement as Secretary at the DF, after returning from a week at the BIS in Basle. He reported being apprehensive about another sterling devaluation. He said there was little they could do to guard against devaluation, 'except to arrange to have more sterling guaranteed in terms of dollars by being transferred from the Associated Banks to the Central Bank (as I hope to do)'.⁸³⁸

Under the perceived threat of more devaluation, a permanent solution to the transfer of sterling was required. Here the groundwork on the creation of an Irish money market proved important. The CBI had been studying the behaviour of the Associated Banks towards liquidity and had observed that the Associated Banks kept 11-15 per cent of their deposits in 'primary' liquidity form (being cash and near-cash) and treated illiquid Exchequer bills, and British gilts, as a form of 'secondary' liquidity which was reduced⁸³⁹ or topped up if the primary liquidity ratio moved outside those ranges. The CBI's long-term aim was that the banks' secondary liquidity should be filled by Exchequer bills and Irish government securities. In recognition of the fact that such Irish investments were currently illiquid, a target, as a proportion of domestic deposits, of 15 per cent primary liquidity and 25 per cent secondary liquidity, should be the aim.⁸⁴⁰

Whitaker was able to persuade the Associated Banks with carrot and stick. The stick was the approaching new central bank legislation, giving the CBI greater powers over licensing and control of bank liquidity. The carrot was attractive interest rates and

⁸³⁷ CBI:F0610955, 'Credit policy...', CBI, 18/4/1969. Of the £15m repatriation, the proposal was that £10m should be deposited with the CBI and £5m placed with a new (hypothetical) Dublin money market institution

⁸³⁸ CBI:F0611130, Whitaker to Murray, 14/5/1969

⁸³⁹ Rediscounted with the CBI in the case of Exchequer bills

⁸⁴⁰ CBI:F0610955, 'Credit policy...', CBI, 18/4/1969

assurances that liquidity deposited by the banks with the CBI would be invested in real liquid assets. For the purposes of the transfer, the CBI proposed that the Associated Banks maintain a primary liquidity ratio of 12 per cent of deposits. This should be made up of four tranches, one of sterling cash and near-cash, one of Irish notes and coin, and two being composed of deposits of different terms with the CBI. The 28 July CBI offer is shown in Table 1. The CBI hoped 'that this facility will result in all the sterling now held by the banks against their Irish liabilities, apart from reasonable working balances, being merged with the official external reserves of the Central Bank'.⁸⁴¹

This was not the end of the negotiation. There were bilateral discussions during the month of August, but by mid-August, Whitaker, on holiday, received notice that 'progress is being made', with £16m having been received from Bank of Ireland, with more to follow, and £20m on its way from AIB. The interest rates on the 4 per cent tranche were temporarily tweaked to just below UK Local Authority rates: 'these have been accepted and by and large should work'.⁸⁴² The £40m counter-deposit arrangement was cancelled on 29 August.⁸⁴³ The centralisation of effectively all the Associated Banks' net external assets was achieved. I did not find the exact number for the net external assets transferred by end-August 1969, but, based on the figure of £105m in the May memorandum, the size of this second transfer can be estimated at £65m (after deducting the original £40m transfer). .

⁸⁴¹ CBI:F0610949, 'Interest rates...', CBI, 28/7/1969

⁸⁴² CBI:F0610955, CBI to Whitaker, 15/8/1969

⁸⁴³ CBI:F0610949, 122/68

Share of banks' Irish deposits:	Banks' assets to be held in:	Interest rate offered:	CBI's matching investment:
3%	Sterling cash or near-cash (i.e. not with CBI)	Market rates	NA
3%	Call or short-notice deposit with CBI	1/8% below the UK Treasury bill discount rate	'the most liquid and realisable assets' e.g. UK Treasury bills
4%	Short-term (i.e. < 91 days) deposit with CBI (to include provision for an Irish money market)	From 3/8% above (i.e. 1 day+ deposit) to 1-1/8% above (i.e. 90 day deposit) the UK Treasury bill discount rate	'wider range of investment possibilities', thus interest rates reflect wider London rates
2%	Till money (Irish notes and coin)	None	NA
Amounts transferred by banks to CBI in excess of 12% of deposits	Certificates of deposit with CBI	Yields and terms corresponding to those on UK gilts transferred	NA
Additional secondary liquidity	Irish Exchequer bills	Recently agreed formula equal to 1.075% of UK Treasury bill rate	NA
Additional secondary liquidity	Irish government bonds	'Rates higher than for 90 day Exchequer bills depending on period and current yields on comparable assets'	NA

Table 1: CBI proposal for Associated Banks' liquidity and transfer of assets, 28 July 1969

Source: CBI:F0610949, 'Interest rates...', CBI, 28/7/1969

Note: CBI = Central Bank of Ireland

4.6 The Central Bank Act 1971 and other changes, 1968-72

The balance of power in the tripartite financial system was also altered by the Central Bank Act 1971. In the 1970s the opening of a new branch required CBI approval.⁸⁴⁴

The main justification for the 1971 legislation was to give the CBI responsibility for the licensing of all banks in Ireland. As discussed earlier, this had been a mooted topic for legislation since 1964, and in some ways it suited the Associated Banks, which were facing competition from the unregulated non-Associated Banks. As late as 1967, licensing was the only substantial element of the proposed legislation, whose motivation was 'mainly to safeguard the interests of depositors and to enable the Central Bank to control the growth of external participation in Irish banking'.⁸⁴⁵

However, a year later, the envisaged legislation now included revision to the link with sterling (allowing exchange rate changes by government order rather than statute, and

⁸⁴⁴ Davy Kelleher McCarthy, *The control*, p44

⁸⁴⁵ NAI:2005/159/62, 'Proposed legislation... 1927 to 1966'

thus resolving a conflict, inherent in the sterling link, with IMF rules about consultation regarding parity changes).⁸⁴⁶ There were also provisions for mergers of banks and the eventual transfer of the Exchequer account to the CBI.⁸⁴⁷ The BOI Court noted on 6 June 1968 a letter from Whitaker regarding the government account.⁸⁴⁸

Money market reforms also began to be implemented. Soon after Whitaker's succession as Governor, the CBI took over responsibility for Exchequer bill administration and providing liquidity to short-dated Irish government securities.⁸⁴⁹ Meanwhile the creation of a discount house was debated within the CBI but quietly postponed in favour of imposing liquidity ratios and the banks building up a portfolio of domestic assets.⁸⁵⁰ By November 1969, the Minister for Finance, Haughey, was able to confirm in the Dáil that 'agreement has been reached between the Central Bank and the Associated Banks for the adoption of liquidity ratios'.⁸⁵¹ In 1973, the CBI enhanced liquidity ratios. For the Associated Banks, these requirements were 13 per cent of domestic deposits for primary liquidity (cash and deposits with the CBI) and 31 per cent for secondary liquidity (Exchequer bills and Irish government securities).⁸⁵² Such rules secured a large element of bank funding for the state.

Finally, the Central Bank Act 1971 reduced the representation of the Associated Banks on the CBI board from three to two.⁸⁵³ Even before this date, Haughey had been selective in appointments, e.g. bringing in WJL Ryan (one of the economists proposing repatriation of external assets in 1957 and soon to be chairman of the MMC) in 1967.⁸⁵⁴ Conflict in the tripartite system did not end with the Central Bank Act 1971,

⁸⁴⁶ This had been announced in the Dáil by Haughey on 5/12/1967, and Moynihan spoke to him on 8/12/1967 about ensuring that the CBI be consulted in any decision to alter the exchange rate, CBI:F0611131, 'External parity...', Moynihan, 21/12/1967

⁸⁴⁷ NAI:TSCH/99/1/397, 'Proposed legislation...1927-1964', 21/3/1968

⁸⁴⁸ BOI: Court minute 6/6/1968

⁸⁴⁹ CBI:Chronology, Apr/ and Jul/1969

⁸⁵⁰ CBI:F0609234, 'Towards the establishment...', McGowan

⁸⁵¹ CBI:F0609234, 'Parliamentary question...13th November, 1969', circulated to directors

⁸⁵² Davy Kelleher McCarthy, *The control*, p57

⁸⁵³ CBI:Chronology, Sep/1971

⁸⁵⁴ NAI:TSCH/98/6/151, 'Central bank: membership...', 14/3/1967

but, owing to new licensing and monetary powers, and the deposits of the government and the banks, the CBI was in a stronger position than in 1967, when Carroll, as chairman of the IBSC, had told Moynihan that there were circumstances in which ‘the Banks might feel themselves obliged to decline to follow the advice given by the Central Bank’.⁸⁵⁵

In summary, the significance of these events can be seen in the extent of the change in the liabilities of the CBI (LTNF and GF together) from March 1968 to March 1973. This is shown in both proportionate and actual scale in Figures 13 and 14 respectively.

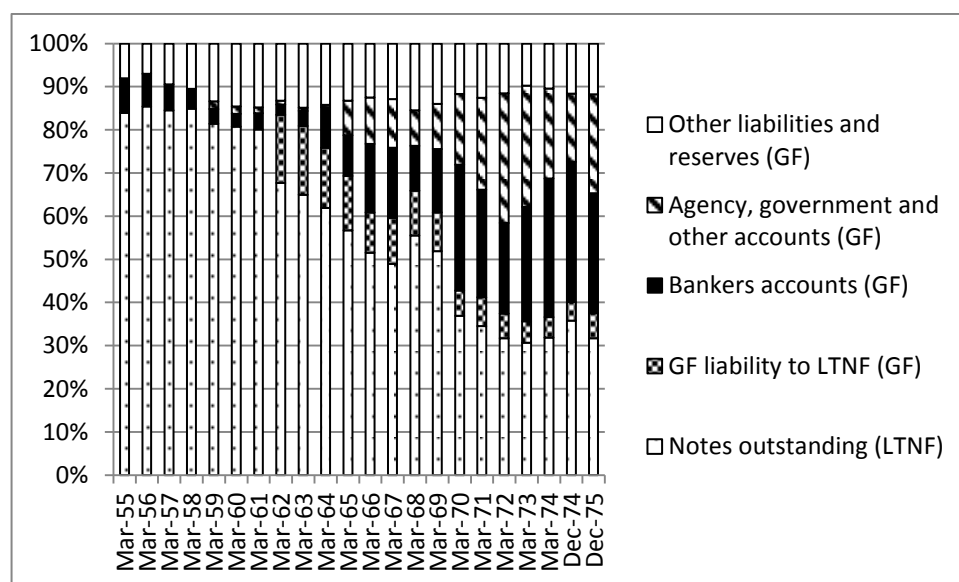


Figure 13: Percentage composition of liabilities of Legal Tender Note Fund and General Fund, CBI, by share of total⁸⁵⁶ liabilities, at end-months shown, March 1955 – December 1975 (%)

Source: CBI annual statements of account, 1955-75

⁸⁵⁵ CBI:F0609233,36/66, Note, Moynihan, 10/3/1967

⁸⁵⁶ Calculated using gross liabilities. One could exclude the GF's liability to the LTNF as a matched inter-fund item

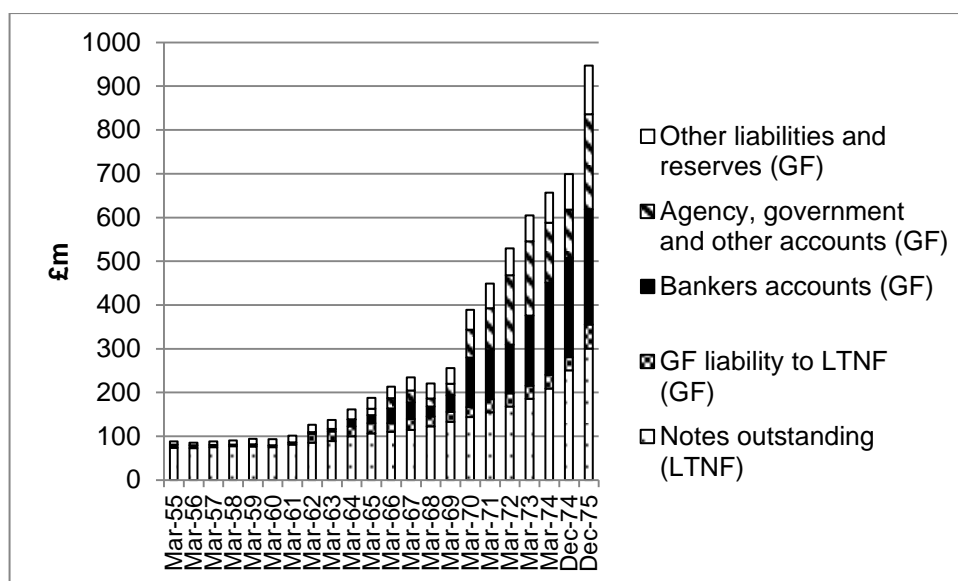


Figure 14: Absolute composition of liabilities of Legal Tender Note Fund and General Fund, CBI, total⁸⁵⁷ liabilities, at end-months shown, March 1955 – December 1975 (£m)

Source: CBI annual statements of account, 1955-75

⁸⁵⁷ Calculated using gross liabilities

This Section explains the diversification of Ireland's 'official external reserves', from sterling into other reserve assets. There were also unofficial, private holdings of sterling in Ireland. In 1949 Whitaker estimated these at £163m (mainly in equities, corporate bonds and gilts) compared with the tripartite official sterling holdings of £237m.⁸⁵⁸ By 1968, the British Treasury was estimating private sterling investments held within Ireland of around £750m.⁸⁵⁹ There is not enough information about private holdings to include them in the analysis.

One can calculate sterling's share of official external reserves from three published sources, Whitaker, Moynihan and the POSB statements of account. These calculations are brought together in Figure 15, which draws two lines – one excluding the Associated Banks, based on Moynihan and the POSB, and one covering all official reserves, from Whitaker. Figure 15 shows that Ireland's diversification was rapid between the end of 1967, when sterling was around 90 per cent of reserves, and the end of 1975, when sterling was less than 20 per cent of the total. It is important also to understand that the changing MSP agreements between Ireland and the UK, which constrained sterling's share, applied from September 1968 to December 1974: without the MSP agreements, diversification would probably have been even more rapid. Our interest lies in the start of this diversification (and the reasons for it) rather than the end, which has been well-covered by Whitaker. By the end, there were fewer constraints on the CBI's action, and the UK's high inflation was at last beginning to call the sterling link into question.

⁸⁵⁸ Whitaker, 'Ireland's external assets'

⁸⁵⁹ TNA:T312/1932, 'Draft (3rd revise)...Ireland'. Exchange controls were meant to limit transfers of capital outside the sterling area, but financial scandals (e.g. the 'Irish leak' or 'Ansbacher deposits') suggest some doubt about their effectiveness. For the 'Irish leak' see Capie, *Bank of England*, pp434-5; for a lively popular account regarding the Ansbacher deposits, Keena, *Haughey's millions*



Figure 15: Sterling's share in Irish official external reserves, annually at 31 December, 1950 – 1976 (%)

Source: Calculated from Whitaker, *Interests*, p139, Moynihan, *Currency*, pp538-9, POSB statements of account, 1950-68

Let us begin with the government's and Associated Banks' position. The underlying numbers show that the POSB external holdings other than sterling were small (not more than £2m equivalent). The Associated Banks' non-sterling external holdings were hard to isolate, but can be inferred at two data points where the two sets of sources overlap, end-1967 (£13m) and end-1968 (£0m).⁸⁶⁰ At first the Associated Banks' low non-sterling holdings seem surprising – why were they not speculating or protecting themselves at a time of sterling weakness? However, a look at their balance sheets at the end of 1967 (see Annex 3) confirms that external non-sterling holdings could only fall into the categories, 'cash and bank balances' or 'money at call at short notice',⁸⁶¹ which together amounted to £154m. Ulster Bank's 'currency balances' were specifically highlighted at only £0.1m. The BOI Court documents did suggest some possible diversification. In March 1967, it opened new bank accounts with two large American banks, each with a maximum limit of £10m equivalent,⁸⁶² 'in order that the

⁸⁶⁰ Calculated from Whitaker, *Interests*, p139 and Moynihan, *Currency*, p539 and POSB, 1967-8 annual statements of account. The calculation in 1967 is £265.8m (Total sterling, Whitaker) minus (£147.3m + £0.8m) (CBI and DF sterling, Moynihan, POSB) = £117.7m (Associated Banks' sterling), which was £13m less than Associated Banks' net external assets of £130.7m (Moynihan)

⁸⁶¹ See CBI:MMC Report, p13. In 1967, according to this Report, around one third of Associated Bank cash and bank balances was Irish but all money at call was external

⁸⁶² BOI: Court minutes, 13/4/1967

bank's call money could be placed to better advantage'.⁸⁶³ This may help to explain the £13m figure. The limited overall diversification by the Associated Banks may owe something to their exchange control policing role, and also to the fact that, with liquidity under pressure, such liquidity needed to be held in the transactional form underlying the sterling link, namely sterling.

5.1 Why the CBI did not diversify, 1965-7

This leaves the CBI as the main focus of attention. Why did the CBI not act earlier to protect itself and diversify its reserves away from sterling, as other leading sterling area countries did?⁸⁶⁴ To some the answer may seem obvious: the CBI was a de facto sterling currency board, and the sterling link, and transactional reliance on the UK, dictated that the CBI should hold predominantly sterling assets. This response is too simplistic: when the diversification began in earnest in 1968, these conditions also still prevailed.

I would contend that two factors constrained the CBI before the 1967 devaluation of sterling. One was the fact that its reserves, before the centralisation of 1968-9, were considered too low to risk holding them significantly in forms other than the currency – sterling – in which its transactional needs were denominated (such as the need to act as LLR to the banks). In other words, the decentralisation of official sterling holdings among CBI and different commercial banks, each feeling liquidity or reserves pressure,

⁸⁶³ BOI: Court minutes, 30/3/1967. The context of these account openings can be explained. BOI's foreign manager periodically approached the Court for permission to open a new currency account with a non-UK bank not currently on the books. The requests were rare: in 1964, there was only one case initiated by BOI (BOI: Court minutes, 1964). In 1965-7, by contrast, there were 13 such records in the Court minutes, most in US dollars, and their timings seemed to coincide with pressure on sterling (e.g. Jan/ and Jul/1965, Sep/1966 and summer-autumn 1967) (BOI: Court minutes, 14/1/1965, 15/7/1965, 14/10/1965, 9/12/1965, 8/9/1966, 30/3/1967, 9/8/1967, 30/8/1967). 1967 was a proactive year for the Court, with Investment Bank of Ireland, the new merchant banking subsidiary, recently appointed investment counsellor to BOI (BOI: Court minutes, 1/12/1966), recommending a new investment policy (BOI: Court minutes, 26/5/1967) and taking oversight over investment, formerly subject to a monthly report from Mullens, the UK government broker and sterling securities specialist (BOI: Court minutes, 20/7/1967).

⁸⁶⁴ Kuwait requested a guarantee from the British in 1961, 1964 and 1966 (TNA: T267/29 'Sterling balances', p82); Australia did so in 1965 (Singleton and Schenk, 'The shift'); Malaysia in 1966 (Schenk, 'Malaysia')

set them up in competition for sterling and increased their aggregate demand for sterling assets. Thus centralisation was the precondition for the full diversification undertaken by Ireland in 1969-75. The other factor is that Irish officials saw in the sterling area an implicit contract with the UK, and so felt constrained by the rules of the sterling area, which did not welcome diversification from sterling, so long as the UK authorities kept their end of the bargain and maintained sterling's parity with the dollar.

Irish officials were concerned about sterling's risks in 1965-7. On 4 January 1965, the Taoiseach (Lemass) wrote to the Minister for Finance (Ryan) requesting views on action 'to minimise the consequences for this country' in the event of sterling being devalued. The latter confirmed that the DF and CBI had already been considering the matter.⁸⁶⁵ In June 1965, the Cabinet decided not to diversify (for reasons discussed below), but to consider the feasibility of diversification if uncertainty continued.⁸⁶⁶

Later, Whitaker was proactive in writing to the Governor of the CBI, Moynihan, warning about sterling's risks. In July 1966, he told him that the summer looked like a period of strain for sterling.⁸⁶⁷ In October 1966, Whitaker wrote to him again about sterling's doubtful prospects and the diversification of other countries.⁸⁶⁸ In his brief for negotiations with the British in March 1968, Whitaker wrote that Ireland had been 'acutely conscious' of sterling risk in the years prior to devaluation. It had been slow 'to the point of being blameworthy' in diversifying, but this was 'out of consideration for the weakness of sterling'.⁸⁶⁹

Whitaker's personal concerns about devaluation risk can be inferred from the government's external borrowing programme in 1966. Whitaker's preference was to

⁸⁶⁵ NAI:TSCH/96/6/533, Lemass-Ryan correspondence, 4-5/1/1965

⁸⁶⁶ NAI:TSCH/96/6/533, '...international monetary position', MfF, 10/6/1967

⁸⁶⁷ CBI:FO611123,34/65, Whitaker, 13/7/1966

⁸⁶⁸ CBI:FO611123,34/65, Whitaker to Moynihan, 18/10/1966, Moynihan's handwritten note, 14/12/1966

⁸⁶⁹ NAI:FIN/2002/19/530, 'Diversification of reserves', Whitaker, 27/3/1968

borrow in sterling: 'the terms are expensive but there is no exchange risk'.⁸⁷⁰ But the UK Treasury was initially reluctant to give consent to a sterling bond issue and encouraged the Irish to accept the merchant bank SG Warburg's proposal for a 15-year DM bond issue instead. The UK Treasury 'would not regard the terms expensive or the exchange risk undue', the DF delegation reported.⁸⁷¹ This view was not shared by Whitaker, who had serious misgivings about both aspects.⁸⁷² He was proved right by subsequent revaluations of the Deutschemmark.

That was Whitaker: what about the CBI? Below the Governor, views within the CBI about diversification and the widening of its powers could be radical. In response to the government's request for advice in the event of a sterling devaluation, a CBI staff memorandum was issued in April 1965. 'Effects of currency devaluation' recommended retaining parity with sterling (advice that was followed in November 1967), but in other respects the proposals were challenging. The exchange rate should be expressed in terms of gold, not sterling, and changes in the rate should be possible by government order rather than new legislation.⁸⁷³ The rules of the LTNF should allow Irish notes to be issued against currencies other than sterling, and the note issue managed on a discretionary basis (abolishing unlimited convertibility) so that the CBI could control the money supply. It also warned against the risks of non-sterling foreign borrowing, asking that the CBI be consulted on any such issuance, and added, 'steps should be taken to accelerate the diversification of the country's external monetary reserves'.⁸⁷⁴

The CBI did not act on this advice in 1965-7. In June 1966, Governor Moynihan indicated to his Bank of England counterpart that Ireland was 'considering some

⁸⁷⁰ NAI:TSCH/2002/8/148, 'Foreign borrowing', 21/1/1966

⁸⁷¹ NAI:TSCH/2002/8/148, 'Inquiries in London...', SF Murray, 14/1/1966

⁸⁷² NAI:TSCH/2002/8/148, Telephone call with Morse, Whitaker, 27/1/1966

⁸⁷³ Addressing the aforementioned conflict with IMF consultation

⁸⁷⁴ CBI:FO611123,34/65, 'Effects of currency devaluation'

diversification of reserves involving a moderate movement out of sterling', citing 'the need to meet liabilities in respect of foreign borrowing'.⁸⁷⁵ But, as Whitaker later wrote, after the British July 1966 measures to defend the pound, 'we judged it inopportune to follow up this indication with any definite plans'.⁸⁷⁶ A CBI memorandum, 'A look at sterling' was circulated to the directors on 13 November 1967. It was negative on sterling's prospects, but too late for action: the devaluation came five days later.⁸⁷⁷

Moynihan himself was cautious about diversifying from sterling. He did not wish to overstretch the scarce sterling resources of the CBI given the sterling link. This comes out in several episodes. In December 1966, he told Whitaker it was not the time to put any of the April 1965 memorandum's recommendations into legislative proposals. Whitaker, although agreeing, 'reserved the right to press the matter' at another time.⁸⁷⁸ Moynihan also told the heads of AIB and Bank of Ireland in April 1967 that 'preservation of the parity link with sterling was a primary responsibility of the Central Bank under the existing law; and this required the Central Bank to maintain a strong external, and particularly a strong sterling, position'.⁸⁷⁹ Finally, Moynihan caused Whitaker to scale back his initial diversification demands in March 1968, saying it would be operationally impractical for the CBI to allow its sterling holdings to fall so low.⁸⁸⁰ Moynihan's concern about insufficient sterling holdings shows the effect of the decentralisation of sterling holdings in Ireland.

The constraints of sterling area membership were the second factor preventing diversification. Meenan argued that Ireland at this time neither gained nor lost from association with the sterling area. Ireland had had a direct dollar deficit after the war, but since 1955 had enjoyed a surplus. It had a natural interest in sterling, given the

⁸⁷⁵ CBI:FO611123,34/65, 'Devaluation of sterling...', Moynihan, 21/11/1967

⁸⁷⁶ NAI:FIN/2002/19/530, 'Diversification of reserves', Whitaker, 27/3/1968

⁸⁷⁷ CBI:FO611123,34/65, 'A look at sterling', Nov/1967

⁸⁷⁸ CBI:FO611123,34/65, Whitaker to Moynihan, 18/10/1966, Moynihan's handwritten note, 14/12/1966

⁸⁷⁹ CBI:FO609233,32/67, Note, Moynihan, 14/4/1967

⁸⁸⁰ NAI:FIN/2002/19/530, 'Diversification of reserves', Whitaker, 29/3/1968

sterling link, but had been disconnected from sterling area meetings because it was no longer a Commonwealth country, and had not had much cause to borrow in the London market.⁸⁸¹ Whitaker's negotiating brief in March 1968 argued that Ireland had a payments surplus with both sterling and dollar areas, but a large deficit with continental Europe. The latter deficit was his justification for increasing the CBI's non-sterling reserves.⁸⁸²

By converting its dollar payments surplus into sterling, Ireland was following the sterling area's 'pooling rule', maintaining sterling as its reserve currency, converting non-sterling proceeds into sterling, and converting its sterling reserves when it needed to make non-sterling payments. Following the pooling rule was different from being deliberately loyal or supportive to the British: it involved payments flows in both directions. When the CBI wrote to the Bank of England in December 1964 asking it for agreement to supply the gold for a selective increase in Ireland's quota at the IMF, the request was not coming at a good time for sterling. But an affirmative answer was expected and indeed given.⁸⁸³

When, in June 1965, the Irish Cabinet decided not to diversify, it was argued that diversification would be incompatible with the obligations of sterling area membership, from which Ireland had gained much benefit; it would signal Ireland's lack of confidence in sterling and be seen as an unfriendly act.⁸⁸⁴ Moynihan later told the British that the decision not to diversify reflected, 'among other things, the interests of the sterling area as a whole'.⁸⁸⁵ But the UK was also expected to perform its sterling area role by avoiding devaluation. In July 1965, in answer to a question in the Dáil about sterling devaluation, the Minister for Finance referenced the statutory link with

⁸⁸¹ Meenan, *The Irish economy*, p363

⁸⁸² NAI:FIN/2002/19/530, 'Diversification of reserves', Whitaker, 27/3/1968

⁸⁸³ BOE:C43/467, Carroll to Hollom, 11/12/1964. The BOE supplied the gold for Ireland's original 1957 subscription, and the quota increase in 1959

⁸⁸⁴ NAI:TSCH/2/2/25, Cabinet minutes 22/6/1965; NAI:TSCH/96/6/533, '...international monetary position', MfF, 10/6/1967

⁸⁸⁵ CBI:FO611123,34/65, 'Devaluation of sterling...', Moynihan, 21/11/1967

sterling, and said, regarding offsetting actions, 'it would be injudicious to take action before the event'.⁸⁸⁶ By implication, after the event was a different matter. Ireland faithfully followed the sterling area's pooling rule until devaluation, after which all bets were off.

5.2 Ireland's 1968 diversification negotiations, February-June 1968

In 1983 Whitaker described the 1967 sterling devaluation as ringing 'the death-knell of sterling as an international currency'.⁸⁸⁷ His account of Ireland's decision to diversify is repeated here:

'Towards the end of 1967 agreement was reached between the Department of Finance (where I was Secretary) and the Central Bank (Dr Moynihan being Governor) on a policy of diversifying the external reserves. I explained our position to the UK Treasury: they did not welcome our intentions but could not resist the logic of our argument. It was agreed that, to avoid any undue repercussions on sterling, we would proceed quietly and by stages from March 1968 onwards towards our objective which, as then defined with deliberate modesty and sensitivity, was to change about half the Bank's own sterling into other reserve assets'.⁸⁸⁸

A review of the Irish and British archival evidence suggests a more complicated and stormy story, however. The diversification plan was greater than that later stated by Whitaker, but he was negotiated down. There seems to have been a significant change in the intensity of the programme between February and March 1968. There

⁸⁸⁶ NAI:TSCH/96/6/533, Dáil, p1009, 13/7/1965

⁸⁸⁷ Whitaker, *Interests*, p130

⁸⁸⁸ Whitaker, *Interests*, pp130-1

were other, including political, factors behind the Irish decision to diversify. And the British did not accept Ireland's plan.

The negotiations are detailed below, and a summary provided in Annex 4. The timing may be addressed first. Whitaker's opposite number at the British Treasury was William Armstrong. On 14 February, on a visit to the UK with the Taoiseach, Whitaker tried to see Armstrong at short notice and in his absence spoke to Arthur Snelling of the Commonwealth Office. According to the British report of this meeting, Whitaker remarked that 'a certain amount of pressure was developing upon him now to undertake a measure of diversification'. This was to cover past foreign borrowings with additional diversification on top, but 'he was not in any hurry', 'gradualism was his watchword', and before doing anything he would wish to discuss the matter with the UK Treasury and the Bank of England after the UK Budget on 19 March – 'probably well after it'. According to Snelling, Whitaker 'seemed quite relaxed about it'.⁸⁸⁹

This gradualist approach was confirmed by Whitaker's own record of the 14 February meeting. After telling Snelling that any diversification would be the subject of prior discussion with the Treasury and Bank of England, he went on to add that 'the Governor of the Central Bank would have the opportunity of broaching the subject again with the Bank of England in May or June next'.⁸⁹⁰

The Irish position changed suddenly after the UK Budget on 19 March. By 21 March, an appointment for Whitaker to see Armstrong had been set up for 28 March.⁸⁹¹ The British embassy in Dublin reported to London that Whitaker had recently told them that the Chancellor's decision in the 1968 Budget to extend the May 1966 'Voluntary Programme' was one factor which had made the Irish determined to diversify. Another

⁸⁸⁹ TNA:T312/1931, 'Irish republic', Snelling, 14/2/1968; '..Whitaker's call on...Armstrong', Norton to Ryrie, 26/3/1968, with accompanying memorandum, 'Diversification'

⁸⁹⁰ NAI:TSCH/96/6/135, Memorandum, Whitaker, 19/2/1968

⁸⁹¹ TNA:T312/1931, 'Visit of...Whitaker', Hawtin to Ryrie, 21/3/1968

factor was pressure from the Opposition in the Dáil.⁸⁹² This was also the time of the March 1968 gold crisis.⁸⁹³ The UK's Voluntary Programme sought to prevent direct investment by British companies in Ireland, Australia, New Zealand and South Africa. This limit on capital flow had always vexed the Irish authorities⁸⁹⁴ and had formed a significant part of Whitaker's discussion with Snelling in February.⁸⁹⁵

The planned scale of diversification was also greater than Whitaker later suggested. The CBI's sterling assets towards the end of February 1968 stood at around £150m, so 'half the Bank's own sterling' would have implied a switch of about £75m. In reality, the brief accompanying Whitaker's meeting with Armstrong talked about reaching 40-50 per cent of total monetary reserves in non-sterling form, quantified in the paper as 'a total fresh acquisition of gold, IMF credits, and selected currencies of about £100m over [the next year or so]'.⁸⁹⁶ The holding preference for Ireland was, in declining order: gold, IMF credits,⁸⁹⁷ Swiss francs and Deutschemarks, dollars, sterling. The immediate priority was to buy gold, where an increase in the dollar price was likely. The brief argued that Ireland's reserve needs were for European currencies, not dollars or sterling. It also highlighted the lack of confidence and loyalty shown by other sterling area countries, and noted that Zambia, Malaysia, Malta and Hong Kong all planned to reduce their sterling holdings. In terms of how to increase non-sterling holdings by £100m, the brief suggested continuing 'the arrangement made in mid-March under which part of the current commercial banking intake of US dollars is being bought by

⁸⁹² TNA:T312/1931, '...Whitaker's call on...Armstrong', Norton to Ryrie, 26/3/1968

⁸⁹³ According to the British report of the meeting, Whitaker said Irish thinking had been 'mainly influenced by the gold crisis', TNA:T312/1931, 'Irish sterling holdings', Ryrie, 29/3/1968

⁸⁹⁴ See references to the Voluntary Programme in NAI:TSCH/97/6/352, TSCH/97/6/473, TSCH/97/6/474. Both Whitaker and Moynihan asked British contacts about the Voluntary Programme on the day of devaluation and were half-led to believe that the restrictions might now be eased, CBI:F0611123, 'Devaluation of sterling...', Moynihan, 21/11/1967; NAI: FIN/2002/19/530, Whitaker to McCann, 21/11/1967

⁸⁹⁵ TNA:T312/1931, 'Irish republic', Snelling, 14/2/1968

⁸⁹⁶ NAI:FIN/2002/19/530, 'Diversification of reserves', Whitaker, 27/3/1968. The memorandum stated that monetary reserves at 20/2/1968 stood at £297m, of which only £25.5m (£28m by 20/3/1968) was non-sterling. Assuming unchanged total reserves, to achieve 40-50% in non-sterling form would require a switch relative to 20/3/1968 of £91-121m

⁸⁹⁷ Ireland could acquire a gold-linked IMF credit (super-gold tranche) by encouraging the drawing of Irish pounds. Ireland used this facility to its full capacity (75% of its IMF quota) in the ensuing years

the Central Bank and converted into gold' (normally according to sterling area rules such dollar accruals would have been sold for sterling by the banks), which could produce £25m in a full year 'without notice being focussed upon it', and more if desired; and the balance by selling sterling for other assets in stages.⁸⁹⁸

According to Whitaker's report of the meeting on 28 March, he told Armstrong and Snelling that the target for non-sterling reserves was 40 per cent of £300m (i.e. £120m), and that Ireland intended to increase non-sterling holdings by £90m by the end of the year. (Moynihan had recently told him that a CBI sterling reserve as low as £40m would be operationally impractical, so he scaled down his demand). Among other reasons for diversification, he cited recent signals and statements that the British planned to reduce sterling's role as a reserve currency. Armstrong said he understood, but the pace was too fast. Snelling countered with a proposal for 1968 of £25-30m currency acquired from Irish commercial banks, with additional building up of credits at the IMF i.e. no switching of sterling. Whitaker said this was not enough.⁸⁹⁹ According to their report, the British interpreted £90m as the final target and that in the current year Whitaker only wanted to move as far along as possible towards the target, meaning, they thought, perhaps £50m in 1968, of which £10m would come from an increase in Ireland's credit position with the IMF (a misinterpretation of Whitaker's position which in fact proved fairly accurate – see below). The British Treasury said they would consult with the Bank of England and revert to Whitaker by end-April.⁹⁰⁰

On 29 March, Whitaker telephoned the UK Treasury to agree that in the meantime Ireland would continue to accumulate currencies from the Irish commercial banks, and additionally switch sterling at the rate of £1.5m per week.⁹⁰¹ The British heard this as

⁸⁹⁸ NAI:FIN/2002/19/530, 'Diversification of reserves', Whitaker, 27/3/1968

⁸⁹⁹ NAI:FIN/2002/19/530, 'Diversification of reserves', Whitaker, 29/3/1968

⁹⁰⁰ TNA:T312/1931, 'Irish sterling holdings', Ryrie, 29/3/1968

⁹⁰¹ NAI:FIN/2002/19/530, 'Diversification of reserves', Whitaker, 29/3/1968

only accumulating currencies at the rate of £1-1.5m per week.⁹⁰² The Bank of England Governor O'Brien replied to Armstrong on 4 April with a firm negative to Whitaker's proposal. 40 per cent was inappropriate given Ireland's close UK links; such a share, if accepted, should only apply to the CBI's reserves; and Ireland should stop diversifying in the meantime. The Treasury then tried to arrange a meeting in short order with Whitaker, but due to the Irish Budget this had to be fixed for 26 April. The British asked Whitaker to refrain from diversifying ahead of an agreement but he firmly resisted the suggestion.⁹⁰³

At the pre-meeting held by the UK Treasury and Bank of England, the instructions for Douglas Allen (Armstrong's successor) were strongly worded. Ireland's target for further diversification should be £20m only, with only £5m in 1968.⁹⁰⁴ The Bank had been monitoring Irish transactions: having bought £5m gold in March, Ireland had been buying dollars throughout April at the rate of \$5m a week, the dollar proceeds being used to buy gold in New York.⁹⁰⁵ If Whitaker reacted badly to the British proposal, he could be warned that the Irish plans called into question 'the whole structure of Anglo-Irish relations'.⁹⁰⁶ That was the first draft. It was amended to a hint that exchange controls might be imposed on Ireland.⁹⁰⁷

At the meeting on 26 April, Whitaker suggested that Ireland could limit further diversification to £45m in 1968, but the British would not countenance more than about £15-20m and proposed that the Chancellor should now write formally to the Irish Minister for Finance.⁹⁰⁸ Whitaker, presumably concerned about the likely outcome from a political row between two tough personalities (Jenkins and Haughey), went to some

⁹⁰² TNA:T312/1931, 'Irish diversification', Hawtin, 29/3/1968; 'Irish diversification', Ryrie, 5/4/1968

⁹⁰³ TNA:T312/1931, 'Diversification by Ireland', Goldman to Allen, 9/4/1968

⁹⁰⁴ TNA:T312/1931, 'Irish Republic: diversification', Norton to Hawtin, 24/4/1968

⁹⁰⁵ The BOE regarded this 'as the last straw' and were urging Allen to take a strong line, TNA:T312/1931, 'Irish Republic: diversification', Norton to Hubback, 19/4/1968

⁹⁰⁶ TNA:T312/1931, 'Irish Republic: diversification', Norton to Hawtin, 22/4/1968

⁹⁰⁷ TNA:T312/1931, 'Irish Republic: diversification', Norton to Hawtin, 24/4/1968

⁹⁰⁸ TNA:T312/1931, 'Irish Republic: diversification', Ryrie, 26/4/1968

lengths to persuade the British to keep the Anglo-Irish dialogue at the official level.⁹⁰⁹ He also tried to explain that the net external assets of the Irish commercial banks were, in fact, part of Irish official reserves.⁹¹⁰ Allen's letter to Whitaker of 9 May, which now requested that Ireland limit diversification to £15m in 1968, included a message from the Chancellor that Irish plans caused him grave concern, and set out the difficulties for Britain. Allen said that sterling's reserve currency role might not expand but, if it were to be reduced, this could only happen gradually and with external support. Of the Irish plan, the letter stated, 'No sterling area country has moved so far so fast'.⁹¹¹

Whitaker was in Sweden until 20 May, so the letter was hand-delivered to him by the British ambassador on his return.⁹¹² He was unimpressed.⁹¹³ He wrote back on 23 May, reiterating that £90m diversification was Ireland's reasonable desire, and it was in recognition of the UK's transitional difficulties that he had proposed £45m. He had now, as a compromise, secured the agreement of the CBI and Minister for Finance that the central bank would, towards Ireland's aim, continue the buying of the Associated Banks' FX accruals, which was unlikely to reach £25m by end-1968. He added that the net external assets of the Associated Banks were quite properly official reserves, and if it would help avoid adverse comment and publicity about Ireland's diversification, he could arrange to have some of those sterling assets transferred to the central bank to enhance the CBI's sterling proportion. If external support for sterling in the form of a guarantee were to become forthcoming, say, in 1969, Ireland could look at its policy again.⁹¹⁴ This was, the British ambassador advised, Ireland's last word.⁹¹⁵

⁹⁰⁹ TNA:T312/1931, Snelling to Allen, 26/4/1968

⁹¹⁰ TNA:T312/1931, Whitaker to Allen, 29/4/1968

⁹¹¹ TNA:T312/1931, Allen to Whitaker, 9/5/1968

⁹¹² TNA:T312/1931, Snelling to Allen, 10/5/1968

⁹¹³ TNA:T312/1931, Gilchrist to Snelling, 20/5/1968

⁹¹⁴ TNA:T312/1931, Whitaker to Allen, 23/5/1968

⁹¹⁵ TNA:T312/1931, Gilchrist to Snelling, 24/5/1968

Still there was no agreement. Allen considered Whitaker's reply unsatisfactory,⁹¹⁶ and the initial UK Treasury response was to prepare a strongly worded letter from Jenkins to Haughey, noting that Ireland had already diversified £14m during the negotiations and demanding that further diversification be limited to £15m.⁹¹⁷ But after some discussion within the Treasury, wiser heads prevailed.⁹¹⁸ By 13 June, thoughts had turned to the possibility of introducing into the Irish negotiations the mooted guarantee for sterling area balances which was to be proposed next month in Basle.⁹¹⁹ Eventually, on 25 June, Allen wrote to Whitaker, noting with gratitude that a £7m IMF drawing of Irish pounds by France (draining British reserves when France redeemed the Irish pounds) would be included within the £25m target, and highlighting the general message Jenkins had already sent to Haughey about the Basle guarantee negotiations.⁹²⁰ On 28 June, Whitaker confirmed to the British ambassador that Ireland would continue diversification as planned until support proposals became clear.⁹²¹ On 8 July, outline details of the scheme were sent from Jenkins to Haughey.⁹²² On 22 July, the Basle negotiations with Ireland began in Dublin.⁹²³

The significance of these negotiations is that Ireland, having been slow to diversify up to 1967, was now prepared to diversify at a considerable pace. While Whitaker wanted to proceed by consultation and agreement, he was not deterred by loyalty; or the sheer scale of Ireland's holdings; or its monetary or trade dependence on the UK. The UK officials used all these arguments, but they no longer carried weight with Whitaker and his colleagues in Dublin. These were not particularly amicable negotiations.

⁹¹⁶ TNA:T312/1931, 'Irish Republic: diversification...', Allen to Chancellor's PPS, 24/6/1968

⁹¹⁷ TNA:T312/1931, 'Irish Republic: diversification', Norton to Ryrie, 11/6/1968

⁹¹⁸ TNA:T312/1931, 'Irish Republic: diversification', Ryrie to Figgures, 12/6/1968; Figgures to Goldman, 12/6/1968; Goldman to Allen, 13/6/1968

⁹¹⁹ TNA:T312/1931, 'Irish Republic: diversification', Goldman to Allen, 13/6/1968

⁹²⁰ TNA:T312/1931, Allen to Whitaker, 25/6/1968

⁹²¹ NAI:FIN/2002/19/530, Whitaker to Moynihan, 28/6/1968

⁹²² NAI:FIN/2002/19/530, Piper to Haughey, 8/7/1968

⁹²³ TNA:T312/1931, 'Sterling balances plan; Ireland', Goldman, 23/7/1968

Who was driving Ireland's diversification? It was not Moynihan, and Whitaker himself seemed cautious about the brief he was negotiating, while his messages to the British in February and March were inconsistent with each other, suggesting a new external impetus for change. The answer to the question is not known, but a reasonable guess would be intervention by Haughey himself. There had been political criticism that Ireland had not anticipated the devaluation,⁹²⁴ and the extension of the Voluntary Programme in the UK Budget seemed to be the final straw. The economic and institutional constraints which had upheld sterling holdings in the tripartite financial system were being dismissed, in political fashion, following the devaluation.

Another curious aspect of the negotiations was how far Whitaker was persuaded to move from his opening gambit of £90m diversification in 1968. In effect he compromised to £39m (£14m already executed plus £25m in his final offer). The reasons for this concession are not known. In his letter of 23 May, he mentioned the possibility of a UK guarantee emerging in 1969: perhaps he sensed that the game was about to change anyway. Or perhaps he felt it was not so much of a concession. It was May, he was only binding himself until the end of the year, and the figure of £25 million had originally only been an estimate. Most likely, to switch £90m out of £150m was an ambitious target in the first place. The LTNF's note issue liabilities, which underlay the convertible sterling exchange standard, stood at £122m at end-March 1968.⁹²⁵ The rediscounting of Exchequer bills at any one time had reached £15m in 1966.⁹²⁶ The CBI had also had to invest £20m in a government loan in 1965. Total official external reserves were also in decline after 1967, falling by £9m in 1968 (with a seasonal low being reached in June – see below), and a further £14m in 1969. These aggregate movements naturally fell on the sterling holdings. There were thus still significant reasons for holding sterling in the CBI's reserves. In the event, the actual increase of

⁹²⁴ See the Dáil debates on 23/11/1967, 28/11/1967, 30/11/1967, 5/12/1967 (NAI:TSCH/99/1/191)

⁹²⁵ See data underlying Figure 3

⁹²⁶ Moynihan, *Currency*, p535

non-sterling reserves during 1968 was £52.6m, made up of £23.0m in gold, £15.3m in IMF gold tranche, and £14.3m in other foreign exchange.⁹²⁷

5.3 The MSP negotiations, July-September 1968, and subsequently

Schenk described the Basle Agreement negotiations of other large holders of sterling in 1968.⁹²⁸ Ireland's negotiations were not as difficult and protracted as those of Australia, Kuwait and Malaysia. Agreement had largely been secured by early September. But negotiations were not easy. The biggest area of dispute, as for most countries, was over the MSP, the minimum percentage of official⁹²⁹ reserves which was to be maintained in sterling under the guarantee agreement. The end-June 1968 position was taken as the basis for negotiations. The British estimated that the share of sterling in Irish official reserves at the end of May was 68 per cent.⁹³⁰ However the sterling share as finally reported by Ireland at end-June was less than 63 per cent.⁹³¹ The decline was attributable partly to continuing diversification and partly to a seasonal low-point in reserves, which had fallen on the sterling holdings.⁹³²

How did these negotiations compare with those of other countries in terms of the end result? For a broader perspective, one can contrast the percentage share of official reserves in sterling just before the devaluation, at end-October 1967, with the published MSPs agreed by other countries in September 1968. These numbers are shown in Table 2.

⁹²⁷ Whitaker, *Interests*, p139. The focus on gold proved temporary. In the other main diversification years, 1969, 1971 and 1974-6, the increases were mainly in 'other foreign exchange' (p139)

⁹²⁸ Schenk, *The decline*, pp300-10

⁹²⁹ 'Official' here means the British definition of central bank and government holdings only, not the Irish definition, which included the Associated Banks

⁹³⁰ TNA:T312/1932, 'Draft, 3rd revise...Ireland'

⁹³¹ TNA:T312/1932, Goldman to Hollom, 30/8/1968. The precise figures given were £97.9m/£155.9m = 62.8%. These confirmed figures were different from the indicative figures reported at the first negotiation meeting on 21/7/1968, which were £82.5m/£143.4m = 57.5% (TNA:T312/1932, 'The Basle scheme...Ireland', BOE, 23/7/1968)

⁹³² TNA:T312/1932, 'The Basle scheme...Ireland', BOE, 23/7/1968

	Sterling's percentage share of official reserves, 31 Oct 1967	Minimum Sterling Proportion (MSP) published, September 1968
Ireland	85%	55%
Australia	60%	40%
Hong Kong	100%	99%
India	21%	13%
Kuwait	74%	25%
Malaysia	82%	40%
New Zealand	85%	70%
Singapore	50%	40%

Table 2: Sterling's share of official external reserves in Ireland and selected countries, actual, as at end of October 1967 and agreed Minimum Sterling Proportion in September 1968 (%)

Source: Column 1: BOE:OV44/116; Column 2: Schenk, *The decline*, Table 8.6, p295

It looks from these headline figures as though Whitaker did not negotiate as successfully as Australia, Kuwait and Malaysia. However, his hands were somewhat tied by his concessions in the earlier negotiations, and 55 per cent was a significant improvement on his final offer in May.⁹³³ The Irish did push hard on certain issues, and, with other countries, secured concessions on a charge for the guarantee (no charge), the scale of the guarantee (90 per cent, not 80 per cent, of official sterling holdings) and the length of the agreement (three years, not seven years).⁹³⁴ Moreover, Ireland's closest peer among these countries, in terms of economic and trade dependence on the UK, was probably New Zealand. Indeed, the outcome was closer to New Zealand's than it seemed, because it was agreed with the British that, if the Associated Banks' sterling assets were centralised, the MSP would automatically increase according to a formula (which, in part, implicitly treated the Associated Banks' net external assets as 100 per cent sterling). The first transfer of £40m increased the MSP to 65 per cent, and the full transfer (more forcefully negotiated by Whitaker) increased the MSP to 68 per cent, not far from New Zealand's 70 per cent MSP outcome.

Once it was clear that the British would not guarantee the Associated Banks' holdings, Whitaker tried to negotiate that sterling brought into the CBI from the Associated Banks would not affect the agreed MSP. But the British firmly resisted, despite discussions

⁹³³ TNA:T312/1932, UK-Irish correspondence, 31/7-4/9/1968

⁹³⁴ TNA:T312/2291, Gilchrist to Irish Minister of External Affairs, 23/9/1968

during the month of August, arguing that they would be encouraging further Irish diversification and affecting negotiations elsewhere. In fact, however, the British did agree to guarantee the Australian trading banks' holdings, on the grounds that they held currencies as agents of the Australian central bank. The British did not include these trading bank holdings when calculating the Australian MSP.⁹³⁵

Why did Whitaker concede on this issue and the 55 per cent MSP? He laid particular stress on Ireland receiving 'Most Favoured Nation' treatment in the wider negotiations, securing benefits achieved by others, and his reliance on this British assurance resulted in an early agreement.⁹³⁶ However, when the MSP of Australia (40 per cent) later became public, he reacted with immediate concern, which no doubt reflected Ministerial criticism, on the grounds that Australia's MSP would be significantly lower than its end-September position. He was not satisfied with the British response about Australia, but sought reassurance that there were no other such cases, and this was given. He was mollified in the short term but given the negotiated MSPs of Malaysia (40 per cent) and Kuwait (25 per cent), he would have been justified in later feeling deceived by the British reassurance.⁹³⁷ Perhaps for this reason, Whitaker was to take much tougher positions in subsequent MSP negotiations. Who knows if the perception of a weak negotiation, against the background of a difficult relationship with Haughey, contributed to his leaving the DF in early 1969?

The agreement also reflected Irish concerns about further restriction on UK capital investment in Ireland. Eventually, the British, in a side letter, promised prior consultation if they contemplated such measures, and immediate review of the Basle agreement if they implemented them.⁹³⁸ This was stronger language than had been

⁹³⁵ TNA:T312/2291, 'Sterling area arrangements', Payton to Symons, 21/11/1968

⁹³⁶ TNA:T312/1932, Whitaker to Goldman, 31/7/1968; Goldman to Whitaker, 4/9/1968

⁹³⁷ TNA:T312/1933, Gilchrist to Commonwealth Office, 16-17/9/1968; Note, Goldman, 18/9/1968

⁹³⁸ TNA:T312/1933, Dublin embassy to Commonwealth Office, 18/9/1968; TNA:T312/2291, Jenkins to Haughey, 23/9/1968

conceded to Australia and New Zealand, which proposed consultation following any such action.⁹³⁹

As it turned out, there were ambiguities in the MSP agreement, which became a source of conflict in the succeeding years. The agreement specified that the MSP should be increased to reflect 'block transfers' of sterling from the Associated Banks, but would not be increased in the event of 'other transfers'. The November 1968 transfer was uncontentious (it was a block transfer).⁹⁴⁰ However, in August 1969, Whitaker, now CBI Governor, wrote to the Bank of England about the agreed remaining transfers by the Associated Banks, arguing that some of these were in the 'other' category.⁹⁴¹ He also, in 1970, claimed that non-sterling foreign borrowings by Ireland should not be included as reserves when calculating sterling's share. The onus was on the British to negotiate an increase in the MSP given these developments, and prolonged negotiations were conducted between the central banks. Among other arguments, Whitaker referred to the more favourable MSPs of countries such as Australia and Zambia. Eventually, in September 1970 (more than a year after the August 1969 transfer) an increase in the MSP to 68 per cent was agreed. This figure was lower than the British calculation of 73 per cent. Moreover the Irish continued to claim that future non-sterling borrowings should not count towards reserves in the calculation.⁹⁴²

The subsequent negotiations over the MSP agreements (1970-4) take us too far out of our chosen time period. They are summarised, however, in Annex 5. The original Agreement was extended by two years in September 1971, now with an MSP of 61 per

⁹³⁹ TNA:T312/1932, Commonwealth Office to Dublin and Wellington embassies, 11/9/1968;

TNA:T312/2291, 'Sterling negotiations: Ireland', Lonie to Hay, 24/9/1968

⁹⁴⁰ TNA:T312/2291, Murray to Goldman, 29/11/1968; Bell to Murray, 18/12/1968

⁹⁴¹ TNA:T312/2291, Whitaker to Hollom, 22/8/1969

⁹⁴² TNA:T312/2808, 'Ireland: sterling agreement', BOE, 24/6/1968; Murray to Figgures, 4/9/1970; Figgures to Murray, 15/9/1970

cent (the MSP of all countries was reduced by one-tenth).⁹⁴³ By 1972, Whitaker was arguing against continuing the agreement at all, and an attempted re-negotiation by the British in that year, due to sterling's float, had to be abandoned as the two sides were too far apart.⁹⁴⁴ However, the agreements continued until the end of 1974. The MSP agreements were the effective constraint against Ireland's further diversification. Singleton and Schenk, in the case of Australia, found that sterling's share was always well above the minimum level.⁹⁴⁵ This was not the case in Ireland, where Ireland's sterling share tracked its MSP closely. See Figure 16 which shows the sterling share outcome against the MSP from February 1969 to June 1972. The brief divergence from the MSP in August 1969 reflected the transfer of the remaining net external assets of the Associated Banks.

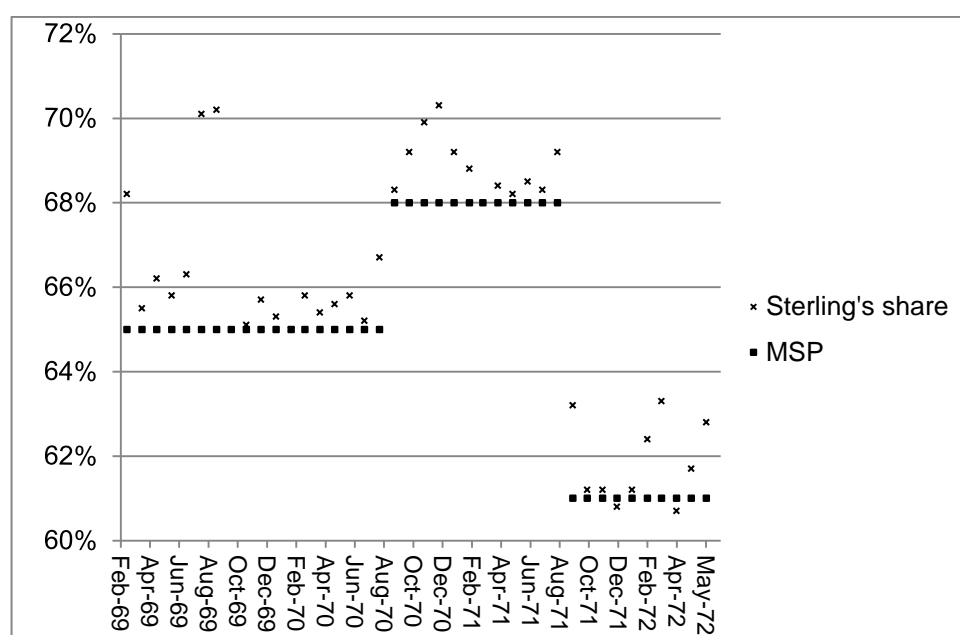


Figure 16: UK-Ireland MSP agreement: sterling's calculated share of external reserves compared to Minimum Sterling Proportion, end-month, February 1969 – June 1972 (%)

Source: CBI:F0706322, 'Central bank: total liabilities and external reserves' 'Meeting on 5th July 1972'; TNA:T312/2291 and T312/2808, monthly MSP notifications

⁹⁴³ NAI:PRES/2002/8/119, 'Renewal of sterling guarantee', 13/9/1971

⁹⁴⁴ NAI:FIN/2004/4/47, 'Sterling guarantee agreement...', 24/7/1972; NAI:FIN/2004/4/313

⁹⁴⁵ Singleton and Schenk, 'The shift'

This paper seeks to understand and locate the transition of Ireland's central bank, the CBI, from a de facto currency board to a central bank. It focuses in particular on the centralisation of the Associated Banks' net external assets into deposits with the CBI, which took place in 1968-9, and the diversification of the CBI's reserves away from sterling, which began in 1968.

Sterling's devaluation in 1967 was the catalyst that led to both events. The UK's implicit breach of promise released Irish policymakers from their sense of sterling area obligation, and Irish politicians seem to have intervened to press for diversification, overruling any reluctance. The active diversification of Ireland and other countries led the UK to try to stabilise the situation by offering a dollar guarantee to official holders of sterling in the sterling area. The guarantee then created an incentive for the centralisation of reserves in the CBI, enhanced by Whitaker's fears about further sterling devaluation. The centralisation in turn allowed more diversification to take place.

This rapid turn of events – perhaps even a 'critical juncture' marked by crisis and policy response – contrasted with the situation before the devaluation. Irish officials considered diversification, but they were constrained not only by the sense of implicit contract in the sterling area, but also by a feeling, held by the CBI's Governor, that the central bank's sterling assets were only just sufficient to fulfil its functions. The Associated Banks were also concerned by their worsening external liquidity (i.e. sterling) position. In other words the decentralisation of sterling assets in Ireland put the holders of sterling into competition with each other, increased the aggregate demand for sterling, and so constrained diversification. At the heart of this impasse was the sterling link and Ireland's currency board system.

There had also been an impasse over centralisation. Government and CBI had long sought centralisation of the Associated Banks' sterling holdings (and the transfer of the government's Exchequer account from Bank of Ireland to the CBI), but the banks had long resisted, as seen in 1961-4, and had blocking power at the CBI's board. Nor were the banks likely to benefit from the UK's offer of an exchange guarantee to the CBI. Among the factors that finally convinced the banks were their individual liquidity problems and declining net external assets, which could be resolved by pooling liquidity risk at the CBI, the promise of a Dublin money market (a process which they had themselves initiated), generous switch terms, and the approach of a new supervisory and liquidity regime. The centralisation does seem, therefore, to have been part of a natural evolutionary process arising partly from liquidity and asset trends in the commercial banking sector – one that proceeded not smoothly but through the mechanism of a tipping point.

Putting the pre-devaluation deadlock into perspective, it can be seen how the sterling area system had self-reinforcing institutional effects on a financially dependent country like Ireland. In 1927, Ireland fitted the category of a small open economy 'wishing to preserve the benefits of belonging to a broader currency area',⁹⁴⁶ after political change, and set up a currency board. In 1942, Ireland established a central bank but retained a currency board system, a transitional arrangement for a country wishing to 'delay the introduction of a full-fledged central bank until they build up central banking expertise or develop financial markets'.⁹⁴⁷ But, as Honohan argued, the currency board arrangement, and use by the banks of the London market for their liquidity needs, deterred financial development in Ireland.⁹⁴⁸ It also, as we have seen, weakened the CBI's GF, consequently delaying central bank activity and hence the acquisition of

⁹⁴⁶ Balino and Enoch, *Currency board arrangements*, p30

⁹⁴⁷ Balino and Enoch, *Currency board arrangements*, p30

⁹⁴⁸ Honohan, 'Currency board', pp55-6

central banking expertise (policy atrophy), and increasing the aggregate appetite for sterling through the decentralised tripartite financial system. Although Ireland was politically independent, the institutional, inertial constraints it experienced in the 1960s were not unlike those highlighted by Schenk for the British colonies in the 1950s.⁹⁴⁹

This paper places the main events in the transition from currency board to central bank into a relatively short period, 1968-72. There were earlier developments, such as the acquisition of dollars into the LTNF (£10m, 1956-8), participation in central clearing (£3m, 1958), an asset in the GF (£20m, 1961), interest on deposits at the CBI (£15m, 1964), deposit of the DF funds (£11m, 1964), and rediscounting of Exchequer bills (up to £15m, 1956-67). But the period 1968-72 saw the centralisation of the banks' net external assets (£105m), the transfer of the Exchequer account (£60m?),⁹⁵⁰ the change in the statutory parity rule, the beginnings of a Dublin money market, new supervisory legislation and liquidity ratios, requiring the Associated Banks to invest at least a quarter of their deposits into Irish government securities, and a major diversification of the CBI's sterling holdings (£148m).⁹⁵¹ There was dramatic change in the liabilities of the central bank.

This paper's account of Ireland's diversification also differs from those seen in the secondary literature. Strange's claims about Ireland's unswerving loyalty leading it to draw from the IMF rather than spend sterling assets,⁹⁵² and its transactional reliance on the UK, making the MSP agreement 'hardly necessary',⁹⁵³ were well off the mark. Ireland's undoubted transactional dependence on the UK, and the sterling link, did not, in fact, prevent it from diversifying when political pressure was applied after the 1967

⁹⁴⁹ Schenk, *Britain*, pp22-5

⁹⁵⁰ The GF's liability to government increased by £60m in the year to Mar/1972 (CBI annual statements of account)

⁹⁵¹ £148m is the amount of non-sterling assets added in 1968-72 (calculated from Whitaker, *Interests*, p139)

⁹⁵² Strange, *Sterling*, p117. We saw that the borrowing was to fund the capital programme, and sterling was the preferred currency for borrowing, but the British limited Irish access to the sterling bond market

⁹⁵³ Strange, *Sterling*, p118

devaluation; the MSP agreements *became* the short-term constraint on diversification. Whitaker's informative but brief account of the diversification only focused on a change in confidence, and, with characteristic diplomacy, glossed over the diversification's political drivers (such as the UK's Voluntary Programme) and stormy negotiations with the UK. A contribution to the literature has been to nuance and amplify Whitaker's memoir using archival evidence.⁹⁵⁴ There is more to be discovered, particularly from the CBI and commercial bank archives, but there is enough evidence to understand what happened.

Ireland is also an unusual case of a currency board arrangement. Currency boards are rare, so each individual case has value in considering their possible efficacy. Although an 'old' currency board, its motivations were modern, like Estonia's, which sets it apart from the colonial currency boards. The economic case for a fixed sterling link was very strong, stronger than Estonia's Deutschemark connections. With this decided, the choice was between a standard peg/central bank (the original intended outcome after a period of transition) and a hard peg/currency board (the de facto outcome). Without a standard peg counterfactual for the 1950s-60s,⁹⁵⁵ it has been judged that Ireland's currency board system was successful, but it is interesting to observe that the currency board advocates have not rushed to embrace the Irish case. Both currency board critics and advocates agree that a fiscal discipline effect would be the main reason for preferring a currency board to a standard peg.⁹⁵⁶ For the system to work, fiscal authorities must abandon discretion and accept a subservient role.⁹⁵⁷ As in Argentina and Bosnia-Herzegovina, this did not happen in Ireland. The 'tranquil currency board'

⁹⁵⁴ The active role of Whitaker in the changes described is clear from the archival record. The CBI became more proactive towards diversification and centralisation under his governorship. While the CBI was unable to constrain the government's fiscal policy in the 1970s, he expressed satisfaction about his contribution in diversifying its reserves and widening its responsibilities (Whitaker, *Interests*, pp141, 185)

⁹⁵⁵ Honohan argued that the 1970s sterling link exhibited more credibility than the later (non-currency board) EMS peg (Honohan, 'Currency board', p54) but it is hard to compare different time periods when a fiscal/debt position is deteriorating over time. In any event, he believed that the sterling link would probably not have survived sterling strength in 1981 (p62)

⁹⁵⁶ Balino and Enoch, *Currency board arrangements*; Hanke, 'Currency boards'

⁹⁵⁷ Schwartz, 'Currency boards'; Williamson, *What role*

was both an orthodox currency board, at the level of the Legal Tender Note Fund, and quite unorthodox, at the level of the wider tripartite financial system, where much heterodox activity (discretionary fiscal policy, monetary financing of the public sector) was taking place outside the control of the CBI, with the government borrowing from the banks, or, in 1966 and the 1970s, from overseas. As in Bosnia-Herzegovina, the resulting pressures on bank liquidity and domestic monetary growth had the effect of calling the CBI to active supervisory duty.

In summary, between 1950 and 1980, Ireland transitioned from a creditor to a debtor nation; and this was not a journey that began only in 1973. The Irish tripartite financial system consisted of a powerful government, entrenched commercial banks, and a weak or constrained central bank. Shocks were absorbed by the banks' excess reserves in the creditor years, but such short-term credibility did not make Ireland's currency board system time-consistent, or necessarily appropriate or more fiscally disciplined relative to a standard peg and less constrained central bank. Organisational constraints and weaknesses may even persist over the long run: in the financial crisis of 2007-9, the CBI was accused of 'excessive deference'.⁹⁵⁸ Perhaps, then, the 'tranquillity' of the 1950s-60s Irish currency board was just a form of irrelevance.

⁹⁵⁸ Barry, 'Diversifying external linkages', p221

Footnote references

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BOE	Bank of England Archive, London
BOI	Bank of Ireland Archive, Dublin
CBI	Central Bank of Ireland Archives, Dublin
NAI	National Archives of Ireland, Dublin
NLI	National Library of Ireland, Dublin
RBS	Royal Bank of Scotland Archives, Edinburgh
UCDA	UCD Archives, Dublin
TNA	The National Archives of the UK, London

CBI, Report of the Money Market Committee, 'Committee on the functions, operation and development of a money market in Ireland' (CBI, 1969) in NLI.

CBI, Annual Statements of Account, in NLI.

CBI, Chronology, 'The history of the central bank 1943-2013', in CBI. (Available from CBI website: <http://www.centralbank.ie/about-us/Documents/The%20History%20of%20the%20Central%20Bank%201943-2013.pdf>, downloaded 00:30 20/02/16)

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Ulster Bank's liquidity deposits and government bill holdings, 1961-9

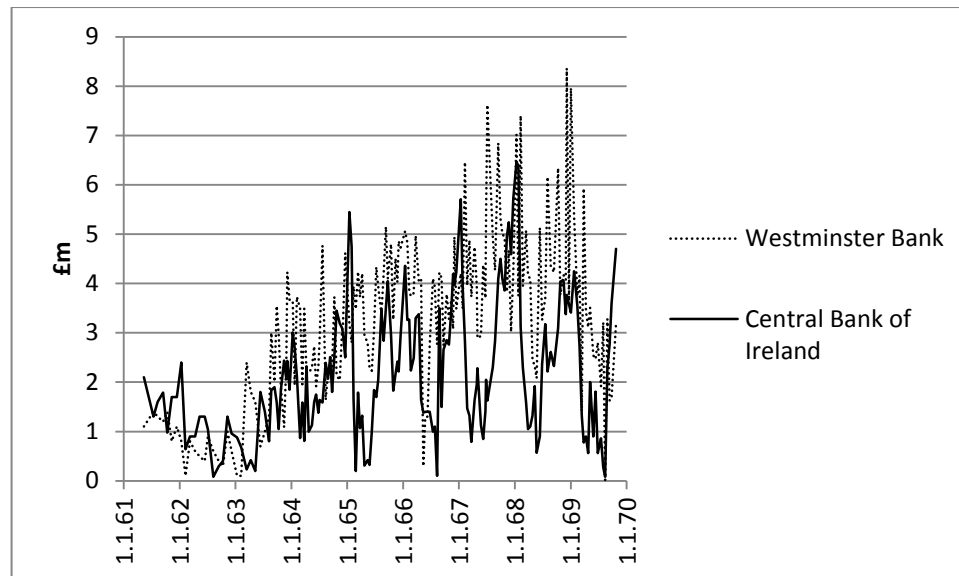


Figure A1: Ulster Bank deposits with CBI and Westminster Bank, as recorded at board meetings, 12 May 1961 – 23 October 1969 (£m)

Source: RBS:ULS/455/19

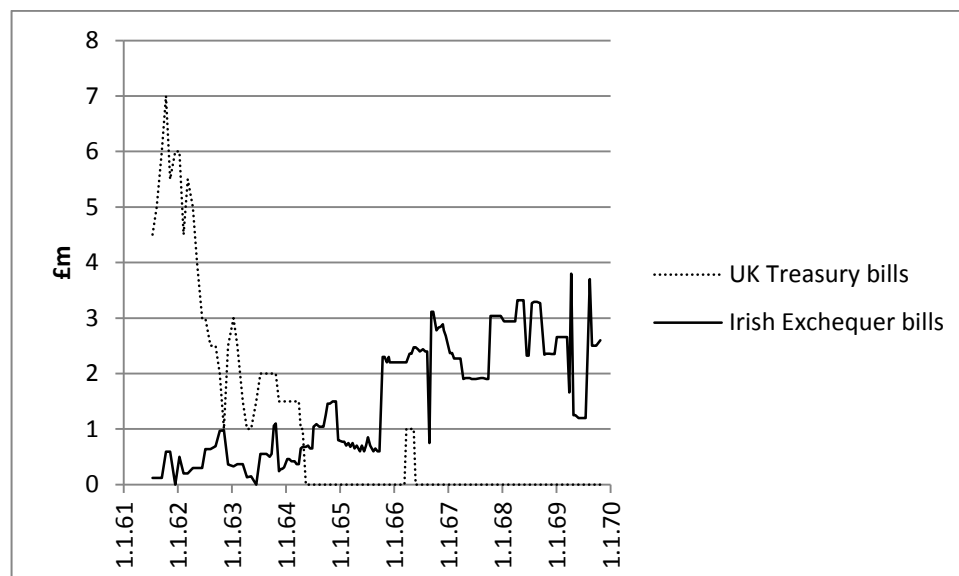


Figure A2: Ulster Bank holdings of Irish Exchequer bills and UK Treasury bills, as recorded at board meetings, 12 May 1961 – 23 October 1969 (£m)

Source: RBS:ULS/455/19

Note: only liquidity for Ulster Bank is shown because of the limited access to the Associated Banks' records. Of the two major Associated Banks (representing around 90 per cent of the total capital of the Associated Banks), the Court records of Bank of Ireland (which I viewed) did not give liquidity figures, and AIB's records were not accessible. Ulster Bank, the larger of the two smaller banks, was therefore chosen. Given its small size and UK ownership, it may not be representative of the larger institutions, however.

Ireland's foreign borrowing programme, 1965-6

Issue month	Amount (£m)	Currency	Coupon	Price (%)	Maturity (years)	Comments
Dec 1965	7.1	US\$	6%	99	20	SEC registered, eurodollar bond. Aborted Nov 1965
Jan 1966	8.0	£:C\$:DM	NA	100	3-5	IMF drawing of US\$22.5m equiv. in ratio 10.5:6:6
Mar 1966	7.0	DM	7%	97.75	15	European bond, also payable in £
Jun 1966	5.0	£	7%	NA	10	Amortising loan from Bank of Nova Scotia (Dublin)
Aug 1966	5.0	£	7.5%	97	17	Offer for sale via Bank of England/Mullens

Table A1: Ireland's 1965-6 foreign borrowing programme, commercial details, December 1965 – August 1966

Source:

External borrowing plan: NAI:TSCH/2/2/25, Cabinet minutes, 'Capital finance', 25/6/1965; 'External borrowing', 31/8/1965

Eurodollar bond: NAI:TSCH/2002/8/148, Memorandum, 'External borrowing', 17/11/1965; handwritten note, 27/11/1965, Secretary, DT; NAI:TSCH/96/6/384, 'Present condition of Harriman Ripley & Co Inc', Department of Finance, 12/5/1966

IMF drawing: NAI:DFA/2006/44/192, correspondence, Dec/1965-Feb/1966

European bond: NAI:TSCH/2002/8/148, 'Inquiries in London on foreign borrowing', SF Murray, 14/1/1966; Whitaker to Lemass, 27/1/1966; NAI:TSCH/2002/8/148, tombstone from The Irish Times, 7/3/1966

Bank of Nova Scotia (BNS) loan: NAI:TSCH/96/6/384, Dáil reports, 5/7/1966, 27/9/1966;

NAI:TSCH/2002/8/148, 'Public capital programme 1966-7: loan from Canadian bank', 26/4/1966. Note: BNS subsequently appeared as an Irish deposit made by the POSB over the next ten years, in amounts ranging from £1.5-2.5m (POSB annual statements of account, 1966-76)

Sterling bond: NAI:TSCH/96/6/384, Dáil report, 27/9/1966. Note: to proceed with this bond, the government had to sign an undertaking that every effort would be made to give British firms an opportunity to supply the import requirements of the Irish public sector (NAI:TSCH/2002/8/148, Memorandum, 'External borrowing', 23/6/1966)

Associated Banks' balance sheets, selected items, 31 December 1967

Selected items at 31 Dec 1967 (£m)	Currencies held	Bank of Ireland	Allied Irish Banks	Ulster Bank	Northern Bank
Cash and bank balances	Any	26.6	31.0	19.6*	18.8
Money at call and short notice	Any	29.5	27.7	0.0	1.2
Irish Exchequer bills	Irish	30.6	20.1	2.9	**
British Treasury bills	UK	0.0	0.0	0.0	**
Quoted securities, Irish and British government	Irish+UK	77.2	53.3	28.1	22.8***
Total assets		376.3	318.1	106.9	98.5

Table A2: Assets of Associated Banks, selected items, 31 December 1967 (£m)

Source: Banks' annual statements of accounts, 1967

Notes: *of which £0.1m were 'currency balances'

**total 'bills discounted' of £1.6m

***British government securities only. In addition there were £3.2m other quoted securities

Note: Consolidated values. The Associated Bank statements of accounts were not particularly informative. For example, Irish and British government securities were combined together in the accounts presentation – it was not possible to separate these two items. It is also not possible to identify the currencies underlying 'cash and bank balances' and 'money at call and short notice' (although Ulster Bank declared 'currency balances', meaning external non-sterling, to be only £0.1m). The categories in the Table match those in the statements of accounts. Due to the creation of Bank of Ireland group in 1965, and Allied Irish Banks group in 1966, the consolidated group figures for these two institutions, rather than their underlying pre-merger banks, are shown in the Table. Displaying the balance sheets of the underlying banks (the legal completion of the mergers had not yet occurred) would not serve a relevant purpose. The balance sheets only for 31 December 1967 are shown because the aim is to show the balance sheet position of the Associated Banks on the eve of the 1968 centralisation and diversification events being studied in this paper. The liquidity trends over time of the Associated Banks are already visible in Figure 12, and the discussion of the 'central bank ratio' in the paper, with accompanying sources. The 1967 year end could be reasonably assumed to be a high point for concern about sterling assets among the Associated Banks, given the recent devaluation and continuing concerns about sterling's prospects. The balance sheets show that the extent of any diversification into non-sterling external currencies was contained within cash and bank balances (some of which were Irish anyway) and money at call and short notice. The two smaller banks had limited money at call because they could place liquidity with their UK parent banks.

Timeline of events during the diversification negotiations, February – July 1968

1968	Form	Key people	Content
14 Feb	Meeting in London	Whitaker, DF and Snelling, CRO	Gradual diversification flagged. Before taking any diversifying action, further discussions to be held both with UKT and BOE 'probably well after' the UK Budget (19 Mar). ⁹⁵⁹ CBI Governor to broach subject with BOE 'in May or June'. ⁹⁶⁰
15 Mar	Crisis		UK bank holiday declared at height of March gold crisis
19 Mar	UK Budget		UK's Voluntary Programme extended
21 Mar	Phone call	DF to UKT	Irish set up meeting for Whitaker and Armstrong on 28 Mar in London. ⁹⁶¹
27 Mar	Memo	Whitaker, DF	Whitaker's briefing document. Approximate £100m diversification planned, with focus on gold ⁹⁶² and IMF credits ⁹⁶³
28 Mar	Meeting in London	Whitaker, DF, Armstrong, UKT, Snelling, CRO	Whitaker targets £90m diversification in 1968. Final target for non-sterling is 40% of total reserves = £120m. ⁹⁶⁴ British, resisting, wrongly interpret £90m as ultimate diversification, of which £50m in 1968. BOE to be consulted ⁹⁶⁵
29 Mar	Phone call	Whitaker to UKT	Whitaker informs British that weekly diversification, already begun in mid-March, will continue ⁹⁶⁶
4 Apr	Not known	O'Brien, BOE, to Armstrong, UKT	Irish plan 'inappropriate'. Maximum in non-sterling should be 40% of CBI reserves (= £70m). Ireland should stop diversifying until agreement reached ⁹⁶⁷
By 9 Apr	Phone call	UKT to DF	UKT try to organise meeting in short order and stop diversification but Whitaker cannot meet until 26 Apr and Irish decline request to stop diversifying ⁹⁶⁸
26 Apr	Meeting in London ⁹⁶⁹	Whitaker, DF, Allen, UKT, Snelling, CRO	Whitaker offers to limit further diversification in 1968 to £45m. Allen counters with no more than £15-20m, and, given no agreement, proposes formal letter from UK Chancellor to Minister for Finance. ⁹⁷⁰ Later Whitaker asks Snelling to try to keep dialogue at official level, fearing adverse consequences ⁹⁷¹
9 May	Letter	Allen, UKT, to Whitaker, DF	Ireland should limit further diversification in 1968 to £15m. Chancellor expressing grave concern. 'No sterling area country has moved so far so fast' ⁹⁷²
23 May	Letter	Whitaker, DF, to Allen, UKT	Whitaker, unimpressed, proposes approximate limit of £25m further diversification in 1968 as final compromise ⁹⁷³

⁹⁵⁹ TNA:T312/1931, 'Irish republic', Snelling, 14/2/1968; 'Dr Whitaker's call on Sir W Armstrong', Norton to Ryrie, 26/3/1968, with accompanying memorandum, 'Diversification'

⁹⁶⁰ NAI:TSCH/96/6/135, Memorandum, Whitaker, 19/2/1968

⁹⁶¹ TNA:T312/1931, 'Visit of Dr TK Whitaker', Hawtin to Ryrie, 21/3/1968

⁹⁶² NAI:FIN/2002/19/530, 'Diversification of reserves', Whitaker, 27/3/1968. The memorandum proposed £100m diversification over the next year or so. It also stated that monetary reserves at 20/2/1968 stood at £297m, of which only £25.5m (£28m by 20/3/1968) was in non-sterling form. To achieve 40-50% in non-sterling form (also a target in the memorandum) would require a switch relative to 20/3/1968 of £91-121m

⁹⁶³ Ireland could acquire a gold-linked IMF credit (super-gold tranche) by encouraging the drawing of Irish pounds. In fact Ireland used this facility to its full capacity (75% of its IMF quota) in the ensuing years (De Vries, *International Monetary Fund 1966-1971*, pp331, 337)

⁹⁶⁴ NAI:FIN/2002/19/530, 'Diversification of reserves', Whitaker, 29/3/1968

⁹⁶⁵ TNA:T312/1931, 'Irish sterling holdings', Ryrie, 29/3/1968

⁹⁶⁶ NAI:FIN/2002/19/530, 'Diversification of reserves', Whitaker, 29/3/1968; TNA:T312/1931, 'Irish diversification', Hawtin, 29/3/1968; 'Irish diversification', Ryrie, 5/4/1968

⁹⁶⁷ TNA:T312/1931, 'Diversification by Ireland', Goldman to Allen, 9/4/1968

⁹⁶⁸ TNA:T312/1931, 'Diversification by Ireland', Goldman to Allen, 9/4/1968

⁹⁶⁹ Ahead of this meeting, Bank and UK Treasury officials urged a strong line, including threatening the imposition of exchange controls against Ireland (TNA:T312/1931, 'Irish Republic: diversification', Norton to Hubback, 19/4/1968; Norton to Hawtin, 22/4/1968; Norton to Hawtin, 24/4/1968)

⁹⁷⁰ TNA:T312/1931, 'Irish Republic: diversification', Ryrie, 26/4/1968

⁹⁷¹ TNA:T312/1931, Snelling to Allen, 26/4/1968. Whitaker also subsequently wrote to Allen, explaining that the Associated Banks' reserves were part of official reserves (TNA:T312/1931, Whitaker to Allen, 29/4/1968)

⁹⁷² TNA:T312/1931, Allen to Whitaker, 9/5/1968

⁹⁷³ TNA:T312/1931, Snelling to Allen, 10/5/1968; Gilchrist to Snelling, 20/5/1968; Whitaker to Allen, 23/5/1968; Gilchrist to Snelling, 24/5/1968

1968	Form	Key people	Content
11 Jun	Draft letter	Within UKT. As from Chancellor to Minister for Finance	UKT drafts letter from Chancellor noting that Ireland has already diversified £14m during negotiations and demanding that it limit further diversification in 1968 to £15m. ⁹⁷⁴ Letter not sent as UKT decide to bring the Basle guarantee into the negotiation ⁹⁷⁵
25 Jun	Letter	Allen, UKT, to Whitaker, DF	Allen implies acceptance of £25m limit and refers to guarantee negotiations in Basle ⁹⁷⁶
22 Jul	Meeting in Dublin	Goldman, UKT, Hollom, BOE, Whitaker, DF, Moynihan, CBI	First meeting held in order to negotiate guarantee/MSP agreement ⁹⁷⁷

Table A3: Timeline of negotiations between Ireland and the UK regarding Irish diversification from sterling, 14 February 1968 – 22 July 1968

Source: See notes to Table

⁹⁷⁴ TNA:T312/1931, 'Irish Republic: diversification of reserves', Allen to Chancellor's Principal Private Secretary, 24/6/1968; 'Irish Republic: diversification', Norton to Ryrie, 11/6/1968

⁹⁷⁵ TNA:T312/1931, 'Irish Republic: diversification', Ryrie to Figgures, 12/6/1968; Figgures to Goldman, 12/6/1968; Goldman to Allen, 13/6/1968

⁹⁷⁶ TNA:T312/1931, Allen to Whitaker, 25/6/1968

⁹⁷⁷ TNA:T312/1931, 'Sterling balances plan; Ireland', Goldman, 23/7/1968. The Chancellor sent an outline of the scheme on 8/7/1968 (NAI:FIN/2002/19/530, Piper to Haughey, 8/7/1968)

Timeline of Ireland-UK MSP agreements, September 1968 – December 1974

Month	Events in the evolution of the MSP agreements
Sep 1968	Broad agreement reached on 4 Sep. ⁹⁷⁸ Three year term. ⁹⁷⁹ Initial MSP set at 55%. Side letter promises consultation if UK contemplates further restriction on capital investment and immediate review of the agreement if it implements such further restriction. ⁹⁸⁰ Whitaker later expresses concern about news of Australia's lower (40%) MSP and seeks reassurance about Ireland's relative treatment ⁹⁸¹
Dec 1968	Following £40m 'block transfer' from Associated Banks to CBI in Nov 1968, MSP increased to 65% in line with agreed formula ⁹⁸²
Sep 1970	MSP increased to 68% as a result of Aug 1969 transfers from Associated Banks to CBI. This follows prolonged negotiations in which sides dispute whether transfers are 'block transfers' or 'other transfers'. ⁹⁸³ Also disputed: Ireland argues that non-sterling foreign borrowings by Ireland should be excluded from reserves when applying MSP. MSP result is concession by UK, which calculates MSP should be 73% ⁹⁸⁴
Sep 1971	Following negotiations since early 1971, MSP reduced to 61% (UK reduces all sterling area MSPs by one-tenth) and agreement extended for further two years ⁹⁸⁵
Jun 1972	Following UK decision to float sterling, UK seeks to agree new MSP, extending agreement until Sep 1975. UK (proposing MSP 61%, then 57%) and Ireland (proposing 40%, then 50%) cannot agree. UK abandons attempt in Sep 1972. Disagreements also over compensation arrangements now that sterling is floating ⁹⁸⁶
Jan 1973	UK pays Ireland £3.8m in compensation for sterling-dollar exchange rate falling below minimum level for 30 days to 23 Nov 1972. CBI claims late payment and interest due ⁹⁸⁷
Sep 1973	Further renewal until Mar 1974 ⁹⁸⁸
Mar 1974	Further renewal until Dec 1974, now guaranteed against currency basket. Final MSP 54% ⁹⁸⁹
Dec 1974	Agreement ends. Total guarantee payments aggregate £11.1m ⁹⁹⁰

Table A4: Timeline of events, the MSP agreements, September 1968 – December 1974

Source: See notes to Table

Note: MSP = Minimum Sterling Proportion

⁹⁷⁸ TNA:T312/1932, Goldman to Whitaker, 4/9/1968⁹⁷⁹ TNA:T312/2291, Gilchrist to Irish Minister of External Affairs, 23/9/1968⁹⁸⁰ TNA:T312/1933, Dublin embassy to Commonwealth Office, 18/9/1968; TNA:T312/2291, Jenkins to Haughey, 23/9/1968⁹⁸¹ TNA:T312/1933, Gilchrist, Dublin embassy to Commonwealth Office, 16/9/1968; Dublin embassy to Commonwealth Office, 16/9/1968; Gilchrist to Commonwealth Office, 17/9/1968; Note, Goldman, 18/9/1968⁹⁸² TNA:T312/2291, Murray to Goldman, 29/11/1968; Bell to Murray, 18/12/1968⁹⁸³ TNA:T312/2291, Whitaker to Hollom, 22/8/1968⁹⁸⁴ TNA:T312/2808, 'Ireland: sterling agreement', BOE, 24/6/1968; Murray to Figgures, 4/9/1970; Figgures to Murray, 15/9/1970⁹⁸⁵ NAI:PRES/2002/8/119, 'Renewal of sterling guarantee agreement', 13/9/1971⁹⁸⁶ NAI:FIN/2004/4/47, 'Sterling guarantee agreement', 24/7/1972; also NAI:FIN/2004/4/313⁹⁸⁷ NAI:FIN/2004/4/47, Circulated to directors, 'Basle sterling agreement', CBI, 20/12/1972;

NAI:FIN/2004/4/47, 'Sterling (Basle) guarantee agreement', 14/6/1973. Ireland finally dropped the interest claim in July 1973 (NAI:FIN/2004/4/47, Murray to Secretary, CBI, 3/7/1973)

⁹⁸⁸ Whitaker, *Interests*, pp136-8⁹⁸⁹ Whitaker, *Interests*, pp136-8⁹⁹⁰ Whitaker, *Interests*, pp136-8

Chapter 4. A co-operative system? Kahn, sterling crises and the sterling area, 1950-67⁹⁹¹

Section 1: Introduction

Economic historians often assume that a fixed exchange rate, international monetary system requires a high degree of co-operation among countries in order to avoid frequent currency crises.⁹⁹² However, documented historical cases of large-scale and sustained international financial co-operation are relatively rare. Whereas historians still debate about the extent of international co-operation during the eras of the classical gold standard (1880-1914) and Bretton Woods (1946-73),⁹⁹³ the sterling area⁹⁹⁴ of the 1950s-60s is often cited as a prominent example of a co-operative international monetary system.⁹⁹⁵

The 1950s and 1960s were however marked by frequent currency crises in the United Kingdom. Between 1950 and 1967, the pound sterling experienced nine crisis episodes and finally devaluation in November 1967. Contemporaries disagreed about the role of the sterling area during these crises. While critics argued that the system was exacerbating sterling crises – specifically through changes in the net liquid external sterling liabilities of the UK, known as the ‘sterling balances’ – incumbent governmental defenders of the system in the Bank of England and UK Treasury claimed that sterling balances were remarkably stable, and that the ‘rest of the sterling

⁹⁹¹ I am grateful for the assistance of staff at the Bank of England Archive and The National Archives of the UK, the Reserve Bank of Australia Archives and the National Archives of Australia. Mike Anson and Forrest Capie were helpful in directing me towards the location of some hard-to-find data (assistance given to the UK during the 1961 sterling crisis). Olly Bush provided helpful feedback on an earlier draft. So too did Lars Boerner and Albrecht Ritschl. During drafting, Olivier Accominotti, Peter Howlett and Joan Rosés provided helpful feedback. All errors are my own

⁹⁹² e.g. Eichengreen, *Golden fetters*; Cesarano, *Monetary theory*

⁹⁹³ Bordo and Schenk, ‘Monetary policy cooperation’; Eichengreen, *Golden fetters*; Flandreau, ‘Central bank cooperation’; Toniolo, *Central bank cooperation*

⁹⁹⁴ The sterling area was a group of countries receiving special exempt status under UK exchange controls and using sterling as their main reserve currency. They were mostly countries associated with the former British Empire, excluding Canada

⁹⁹⁵ Cooper, ‘Almost a century’, p86; Singleton, *Central banking*, pp155, 181

area' (RSA) was consistently contributing to the UK's reserves and even providing assistance to the UK during crises.⁹⁹⁶

This paper explores the role of co-operation within the sterling area during these nine episodes of sterling crisis. I provide an assessment of the scale and timing of these crises and rely on a mixture of published and original, archival data in order to quantify the types and amounts of assistance received by the UK from RSA and 'non-sterling area' (NSA) countries during these episodes. I adopt a contemporary methodology which was used by the British economist, Richard Kahn, to analyse the crises of the 1964-8 period in two government reports,⁹⁹⁷ and extend this methodology to earlier crises. This allows me to explain what was happening to the sterling balances during these crises and shine a light on the balance-of-payments debates of the time.

My main finding is that the crises of the 1950s saw large negative movements in the RSA's sterling balances. This contradicts the defenders' public claim that the sterling balances of the RSA were remarkably stable. These movements were also a regular private concern of the UK authorities. Such changes in member countries' sterling holdings could originate from fundamental balance-of-payments deficits of the RSA countries themselves or from a loss of confidence in sterling during crisis times. I show that changes in the RSA's sterling balances were for the most part (at least until 1964) not confidence movements, but were driven by the RSA's balance of payments, to which (in Kahn's methodology) the movement in the UK's free reserves was a financing counterpart. Therefore, the scope of international co-operation within the sterling area was limited by the area's collective balance-of-payments problem. Co-operation only consisted in a narrow range of measures such as the RSA's pooling of

⁹⁹⁶ For critics, see Shonfield, *British economic policy*, and Jenkins, *A life*, p256. Jenkins became the UK's Chancellor of the Exchequer after the Nov/1967 devaluation of sterling. For the defenders' view, see Section 3

⁹⁹⁷ BOE:EID1/20, 'Enquiry into the position of sterling 1964-65', Kahn, 1/6/1966; BOE:EID1/6, 'Enquiry into the position of sterling, January 1966-February 1968', Vol.I, Kahn, 12/8/1971; BOE:EID1/7, 'Enquiry into the position of sterling, January 1966-February 1968', Vol.II, Kahn, 12/8/1971

reserves (using sterling as their reserve currency). This suggests that, in order to be successful, a co-operative, international monetary system must address the problem of external imbalances.

By contrast, I find that changes in NSA countries' sterling holdings during these crises were primarily due to changes in confidence and international assistance. However, reserves holdings induced by international assistance were a relatively large part of the total NSA sterling holdings. This finding first suggests that the sterling area did benefit from international co-operation, but co-operation mostly came from the NSA rather than RSA countries. The finding also indicates that sterling holdings outside the sterling area would have been limited – if not for the assistance of foreign governments. This suggests that sterling's international role was already severely undermined in the 1950s-60s and derived from its reserve currency use by members of the sterling area, as well as NSA governments' assistance holdings.

The plan of the paper is as follows. Section 2 discusses historical context, literature, methodology, sources and data. Section 3 reviews a 'defender' position – the Bank of England's public and private views on the sterling balances. Section 4 examines data on assistance, showing the true scale of the crises. Section 5 looks at the sterling balances and their role during the crises. Section 6 discusses confidence and assistance within the RSA, and the nature of sterling area co-operation. Section 7 concludes the paper.

Section 2: Historical context, literature, sources, data and methodology

2.1 Historical context

The sterling area system⁹⁹⁸ had its origins in nineteenth century UK trading relationships and the British Empire. The sterling bloc started in 1931, when the UK abandoned the inter-war gold exchange standard, and countries had to choose which reserve asset to follow. In 1939, the system was redefined by UK exchange controls. It formally ended in 1972, when the UK terminated the exchange control exemptions which had been granted to sterling area countries. In 1939-72, countries operating within the ring of controls were expected, in return for the system's privileges,⁹⁹⁹ to follow broad rules, essentially pegging their currencies to sterling, maintaining exchange controls well-aligned with those of the UK, and pooling their reserves by using sterling as their principal reserve currency.¹⁰⁰⁰ For this study, it is the pooling rule that is important.

Because of reserve pooling, the reserve management behaviour of RSA and NSA countries was completely different.¹⁰⁰¹ The sterling holdings of RSA countries fluctuated with their aggregate reserves. Sterling was their transactional reserve currency, the movements in reserves largely reflecting these countries' *fundamental* balance of payments on current and long-term capital account. By contrast the sterling holdings of NSA countries did not fluctuate with their aggregate reserves. Their holdings mainly reflected changing *confidence* in sterling, and, in the case of a few leading countries, *assistance* provided to the UK. This paper seeks to identify

⁹⁹⁸ These initial paragraphs about the sterling area system are based on BEQB:1963Q4, pp264-78, Sargent, 'Britain' and Schenk, *The decline*, pp22, 339

⁹⁹⁹ Such as the ability to exchange sterling against other reserve assets with the BOE, and to receive unrestricted capital flows from the UK

¹⁰⁰⁰ Schenk, *Britain*, p8. The rules were not rigid and were interpreted by each country

¹⁰⁰¹ There were just a few hybrid cases, as discussed in Section 6

fundamental (autonomous), confidence (reactive, exacerbating) and assistance (reactive, mitigating) flows during the sterling crises.

These sterling holdings were generally known to contemporaries as the 'sterling balances'. More precisely, they were the net external short- and medium-term liabilities of entities in the UK, which were denominated in sterling. 'Net' means after deducting all external claims (e.g. acceptances and trade credit) of the UK denominated in sterling. The information about the balances was largely supplied to the Bank of England by its network of reporting banks. The holders of the sterling balances were in turn both official bodies (governments and central monetary institutions (CMIs)) and private organisations and individuals.

This study examines sterling crises in the comparatively stable period between the sterling devaluations of 1949 and 1967. In general, the 1950s-60s was 'one of the most fruitful periods of international economic cooperation'.¹⁰⁰² In the late 1940s, the sterling area had been engaged in post-war reconstruction, and sterling's more than 30 per cent devaluation against the US dollar in September 1949 provided a fundamental readjustment. By the 1950s, it has been argued, the RSA's sterling balances had transitioned from a post-war debt inheritance to a working voluntary regional currency system.¹⁰⁰³

2.2 Literature review – co-operation

International monetary co-operation is a contested field¹⁰⁰⁴ and some do not regard it as beneficial.¹⁰⁰⁵ Examples of international monetary co-operation over the last two centuries include the pre-1914 gold standard, central bank relationships between the

¹⁰⁰² Toniolo, *Central bank cooperation*, p313

¹⁰⁰³ Schenk, *Britain*, p48

¹⁰⁰⁴ Toniolo, *Central bank cooperation*, pp10-13

¹⁰⁰⁵ Obstfeld and Rogoff, 'Global implications'

UK, USA, France and Germany in the 1920s, the Bretton Woods institutional framework of 1946-73, the EPU of 1950-8, central banks' ad hoc efforts to preserve the international monetary system in the 1960s, the Plaza and Louvre Accords of the 1980s, and European monetary co-operation, culminating in European Monetary Union.¹⁰⁰⁶

Among such examples, the sterling area receives prominent mention as a co-operative system. For Cooper:

'the Sterling Area was a cooperative system, with the aim of protecting and ultimately strengthening the position of sterling in international markets while preserving a high degree of commercial and financial freedom within the Sterling Area.'¹⁰⁰⁷

And for Singleton, the sterling area's

'functioning required close cooperation between central bankers, especially in their capacities as government advisors and overseers of exchange control regulations'¹⁰⁰⁸

and

'The management of the sterling area was the main objective of central bank and intergovernmental cooperation in the Commonwealth. Member states and their central banks were expected to collaborate to preserve the dollar pool and protect the external value of sterling. Communication between

¹⁰⁰⁶ Cooper, 'Almost a century'
¹⁰⁰⁷ Cooper, 'Almost a century', p86
¹⁰⁰⁸ Singleton, *Central banking*, p155

Commonwealth central banks was often conducted through the Bank of England. By the 1960s, however, interest in the sterling area relationship was waning.¹⁰⁰⁹

If the co-operative aim of the sterling area was to protect and strengthen sterling in international markets, how was this aim to be achieved? Cooper highlighted multiple possible channels of co-operation, the hardest of which to implement are 'generic rules of behavior', 'mutual financial support' and co-ordinated actions.¹⁰¹⁰ Across the literature, a distinction is made between co-operation that is shallow (broadly, information-sharing) and deep ('policy adjustments that differ from those that would have been taken unilaterally').¹⁰¹¹ Another is the division between informal co-operation ('rules of the game') and formal co-operation ('ad hoc actions'). It is argued that formal co-operation is needed to address financial crises, while informal co-operation can help support longer run international financial stability.¹⁰¹² Most historical cases involved deep, formal co-operation. For instance, the efforts of leading central banks to protect the international monetary system in the 1960s consisted of clear ad hoc policy adjustments in the form of short-term support from creditors to debtors.¹⁰¹³

The exception is the pre-1914 gold standard, where the literature's focus on implicit rules and credibility reveals a predominantly informal system.¹⁰¹⁴ There has been controversy about the extent of international monetary co-operation during this era, with Eichengreen arguing that the system's stability relied on co-operation among central banks,¹⁰¹⁵ while Flandreau, taking a 'sceptical view' of co-operation in the nineteenth century, countered that the relatively rare ad hoc actions by central banks

¹⁰⁰⁹ Singleton, *Central banking*, p181

¹⁰¹⁰ Cooper, 'Almost a century', pp78-80

¹⁰¹¹ Simmons, 'The future', p175; Borio and Toniolo used different words for the same distinction, 'low-key' and 'high-profile' (Borio and Toniolo, 'One hundred and thirty', p17)

¹⁰¹² Toniolo, *Central bank cooperation*, pp5-10

¹⁰¹³ Coombs, *The arena*

¹⁰¹⁴ Cesarano, *Monetary theory*, pp22-41 reviews the gold standard

¹⁰¹⁵ Eichengreen, *Golden fetters*, pp7-8

were self-interested and not motivated by a spirit of co-operation.¹⁰¹⁶ The importance of rules suggests some superficial similarities between the sterling area and the gold standard, although the gold standard debate, like that recently surrounding the euro, was about the system's internal stability, whereas sterling's problem in the 1950s and 1960s was its external stability. Nevertheless the formal-informal differentiation, as well as the question about whether co-operation took place, provides a framework for examining the sterling area.

2.3 Literature review – sterling crises

The historical literature has found it hard to categorise the sterling crises of the 1950s and 1960s, and this has resulted in debate e.g. about the causes of crisis and devaluation in the 1964-7 period.¹⁰¹⁷ Kaminsky describes six classes of currency crisis.¹⁰¹⁸ Of these, three did not appear to apply to sterling in these decades. There was little evidence of market-based 'financial excesses'. 'Sudden stops' and 'self-fulfilling crises' implied no inherent UK vulnerability. Although Newton highlighted such elements,¹⁰¹⁹ the vulnerability of the British economy was the overriding theme of the Kahn Reports.¹⁰²⁰ However, this still leaves a choice whether to allocate the crises to problems of the 'current account' (only the real exchange rate), 'sovereign debt' or 'fiscal deficits'.¹⁰²¹ Gilbert emphasised the first of these, whereas Thirlwall and Gibson did not agree that the UK was in 'fundamental disequilibrium'.¹⁰²² Indeed, the UK's problem was more with its capital account than its current account, which was usually in surplus in these years.¹⁰²³ The sterling balances represented high levels of external

¹⁰¹⁶ Flandreau, 'Central bank cooperation'

¹⁰¹⁷ Newton, 'The sterling devaluation'; Oliver, 'The management'. The Newton–Oliver debate was about the cause of sterling's ultimate devaluation: speculative markets (Newton) or UK balance-of-payments fundamentals (Oliver)

¹⁰¹⁸ Kaminsky, 'Currency crises'

¹⁰¹⁹ Newton, 'The two sterling crises'

¹⁰²⁰ BOE:EID1/20, 'Enquiry' (1964-65) p1

¹⁰²¹ Kaminsky, 'Currency crises'

¹⁰²² Gilbert, *Quest*, p72; Thirlwall and Gibson, *Balance-of-payments theory*, pp219-43

¹⁰²³ Thirlwall and Gibson, *Balance-of-payments theory*, p229

debt¹⁰²⁴ but they were in time matched by (admittedly less liquid) external assets.¹⁰²⁵

Some authors have favoured a fiscal deficit explanation, combined with monetary accommodation.¹⁰²⁶

Some contemporaries (Kahn included) thought that sterling's problems were not entirely domestic in origin.¹⁰²⁷ Such views contrast with the more recent historical literature, which has focused on balance-of-payments problems associated with the UK. Thus Schenk highlighted the UK's

'relatively slow growth in output, productivity and the deteriorating competitiveness that manifested itself in recurring balance of payments crises in the 1950s'.¹⁰²⁸

Schenk was arguing, as Cairncross had done,¹⁰²⁹ that UK domestic weaknesses caused the balance-of-payments problems, whereas Shonfield had claimed that causation ran in the opposite direction, from external policy priorities and sterling crises to domestic production and productivity.¹⁰³⁰

Schenk put forward various reasons why the RSA's sterling balances were not the threat they seemed to pose contemporaries. Sterling area pooling diversified risk. RSA countries spending their sterling reserves were matched by others accumulating them.

¹⁰²⁴ Shonfield, *British economic policy*, p86

¹⁰²⁵ BEQB:1967Q3, pp261-7

¹⁰²⁶ Capie, *Bank of England*, p251; Oliver, 'The management'

¹⁰²⁷ Thus Polk in 1956 concluded that 'the future of sterling lies primarily in the future of the Commonwealth' (Polk, *Sterling*, p262). Conan in 1966, likening the UK's then currency problems to those of the USA, argued that the 'trend for sterling' lay primarily outside the scope of 'the performance of the United Kingdom economy' (Conan, *The problem*, p119). Hirsch thought that the UK balance of payments was only one factor contributing to sterling's weakness (Hirsch, *The pound sterling*, pp24-29, 47-49). Shonfield and Strange were critical of the effects of the sterling area system on the UK (Shonfield, *British economic policy*; Strange, *Sterling*)

¹⁰²⁸ Schenk, *Britain*, pp2-3

¹⁰²⁹ Cairncross, *Managing*, pp8-22

¹⁰³⁰ Shonfield, *British economic policy*. Both causation arguments are criticised by Tomlinson as being symptomatic of an invalid 'declinist' culture in British historiography (Tomlinson, 'Balanced accounts?')

A large part of the RSA's sterling balances was illiquid.¹⁰³¹ Schenk argued that 'the sterling balances did not have a directly destabilising impact on the British economy in the 1950s'.¹⁰³² This was because the RSA had a balance-of-payments surplus, on current and long-term capital account, with the NSA, and so was implicitly contributing gold and dollars to the UK reserves: this surplus was 'a main determinant of the stability of the system'.¹⁰³³ Although highlighting the general stability of the RSA's sterling balances in the 1950s, Schenk did not examine currency crises in detail, arguing that occasional declines in sterling balances motivated by weak confidence in sterling could have been based on the UK's poor fundamentals rather than concerns about the balances.¹⁰³⁴ Schenk also discussed co-operative behaviour (in the sense of co-ordinated action) in the sterling area and found that it was waning from the early 1950s.¹⁰³⁵ Schenk's overall conclusion about the 1950s was unequivocal: 'The balance of payments problems that were the focus of British economic policy in this period cannot be attributed to the existence of the sterling area'.¹⁰³⁶

For the individual crises themselves, confidence and speculation have been the main features highlighted by the literature. Hirsch identified each of the crises and named speculation as a factor in them all, attributing those of 1956 and 1957 to 'pure speculation'.¹⁰³⁷ Boughton described the 1956 Suez crisis as 'almost purely a speculative attack on a stable currency'.¹⁰³⁸ Klug and Smith also emphasised the pace and scale of the speculative flows during the Suez crisis.¹⁰³⁹ Kahn's investigation of the 1964-8 crises took a particularly close interest in confidence and speculative flows.

¹⁰³¹ Schenk, *Britain*, pp20-7

¹⁰³² Schenk, *Britain*, p33

¹⁰³³ Schenk, *Britain*, p49. This particular argument conflicts with Kahn's analysis (see below in this Section and Section 3)

¹⁰³⁴ Schenk, *Britain*, pp33-5

¹⁰³⁵ Schenk, 'British management of the sterling area, 1950-58', 1991 PhD thesis, pp122-214

¹⁰³⁶ Schenk, *Britain*, p136

¹⁰³⁷ Hirsch, *The pound sterling*, pp48-9

¹⁰³⁸ Boughton, 'Northwest of Suez', p443

¹⁰³⁹ Klug and Smith, 'Suez and sterling'

The RSA's sterling balances have generally not been considered relevant factors behind these crises. In 1971 Brittan wrote that 'running down of the sterling area's balances contributed in a major way to only one British crisis, that of 1957, and even here it was not the decisive factor'.¹⁰⁴⁰ Both Fforde and Robbins analysed the 1957 crisis without mentioning the sterling area's balances, highlighting instead the UK's inflationary tendencies, and currency speculation prompted by devaluation of the French franc.¹⁰⁴¹ Where speculation and confidence were not behind the crisis, the UK's balance of payments was thought to be the cause. Thus Schenk found that 'the major culprit in the payments crisis of 1952 was the UK itself'¹⁰⁴² and 'the adverse balance of 1955 was due much more to British deficits than to drains in the RSA'.¹⁰⁴³ In their debate about the 1960s, Newton and Oliver both mentioned the sterling balances, but largely one aspect: loss of confidence in sterling and the risk of diversification into other reserve assets by sterling area countries.¹⁰⁴⁴ Relatively little attention has been paid to the fundamental balance of payments of the RSA, as reflected in the sterling balances.

In summary, there are three regional actors potentially held responsible for sterling crises of this period: the UK (its balance of payments), the NSA (external confidence), and the sterling area. While some contemporaries considered the sterling area partially accountable for sterling's problems, more recently such a view has been discounted.

2.4 The sterling balances and the international balance of payments

The critics and defenders of the sterling area system had fundamentally different mental models of how the international balance of payments, the sterling balances and

¹⁰⁴⁰ Brittan, *Steering*, p445

¹⁰⁴¹ Fforde, *Bank of England*, pp. 568-72; Robbins, 'Thoughts'

¹⁰⁴² Schenk, PhD thesis, p139

¹⁰⁴³ Schenk, PhD thesis, p195

¹⁰⁴⁴ Newton, 'The sterling devaluation' pp914, 925, 938, 940; Oliver, 'The management', pp601-2

the UK's reserves interacted. In order to understand this, it is necessary to consider the international balance of payments in terms of three regional groups, the UK, the RSA and the NSA.

A modern authority on the balance of payments is the IMF's *Balance of Payments Textbook*.¹⁰⁴⁵ This describes how the balance of payments of any country or region sums to zero and consists of the current account (goods and services, income and current transfers) and the capital and financial account. The financial account relates to changes in the external financial assets and liabilities of an economy and covers direct investment, portfolio investment, other investment and reserve assets. In balance-of-payments analysis, some items of the balance of payments (e.g. the current account) are usually treated as autonomous, while others (e.g. reserves in a fixed exchange rate system) are passive, financing those autonomous flows in a compensatory fashion. In a simple, fixed exchange rate world in which there were no other short-term capital flows, the autonomous movements might be taken to be the current account and long-term capital account,¹⁰⁴⁶ and they would be financed by changes in a country's reserves.

Figure 1 sets out a typical payment flow, on current and long-term capital account, between the UK, RSA and NSA. The figures are indicative, for illustrative purposes, but broadly match those prevailing in the late 1950s.¹⁰⁴⁷

¹⁰⁴⁵ IMF, *Balance of payments*

¹⁰⁴⁶ In combination (the current and long-term capital accounts could offset each other)

¹⁰⁴⁷ See Annex 5

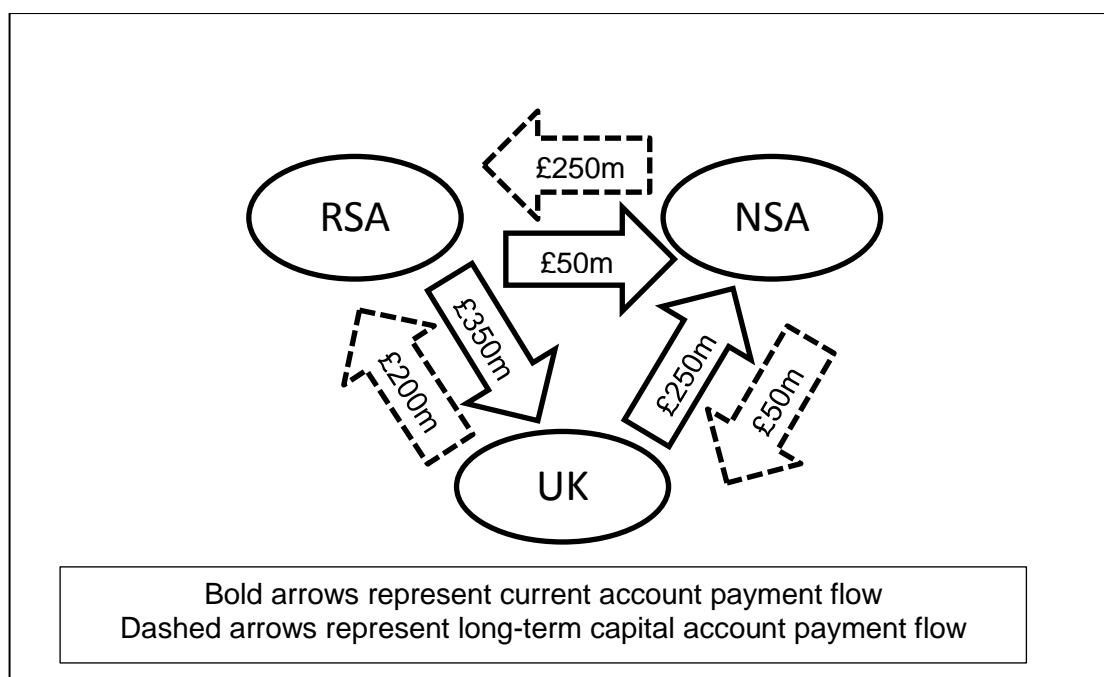


Figure 1: Illustrative annual balance-of-payments flows between UK, RSA and NSA, late 1950s (£m)

Source: Author's illustrative assumptions. See Annex 5 for historical figures

Note: RSA = Rest of the sterling area; NSA = Non-sterling area

These figures show the sterling area (RSA + UK) in overall payments balance with the NSA, with the resulting net positions given in Table 1.

£m	RSA	UK	NSA
Overall current account position	-400	+100	+300
Overall long-term capital account position	+450	-150	-300
Overall balance-of-payments position on current and long-term capital account	+50	-50	0

Table 1: Illustrative annual balance-of-payments statistics for the UK, RSA and NSA in late 1950s (£m)

Source: Calculated from balance-of-payments flows in Figure 1

Note: RSA = Rest of the sterling area; NSA = Non-sterling area

The contemporary critics and defenders of the sterling area system looked at such figures in different ways. Shonfield, a critic, cited the overall current account, and concluded that the UK's sustainable current account surplus (£100m here) was being undermined by outward capital flows (£150m) and the RSA's large current account deficit (£400m).¹⁰⁴⁸ By contrast, defenders of the system tended to look at the balance

¹⁰⁴⁸ Shonfield, *British economic policy*, p134

of payments only with the NSA on current and long-term capital account.¹⁰⁴⁹ The latter approach shows the UK in large deficit (£200m) and the RSA in large surplus (£200m).

The next stage in understanding is to consider how these balance-of-payments flows affected reserves. Again, it is useful initially to make simplifying assumptions, which are, as will be seen, approximations of reality. Here, it can be assumed that the reserves of the UK and NSA consisted entirely of gold and US dollars, while the reserves of the RSA consisted entirely of sterling. Under these assumptions, changes in the RSA's sterling balances (reserves) reflected and financed the RSA's overall balance of payments on current and long-term capital account.

How would a change in the RSA's sterling balances during a sterling crisis affect the UK's own reserves? One must consider all the possible flows of sterling from the RSA to the rest of the world. This is illustrated in Figure 2.

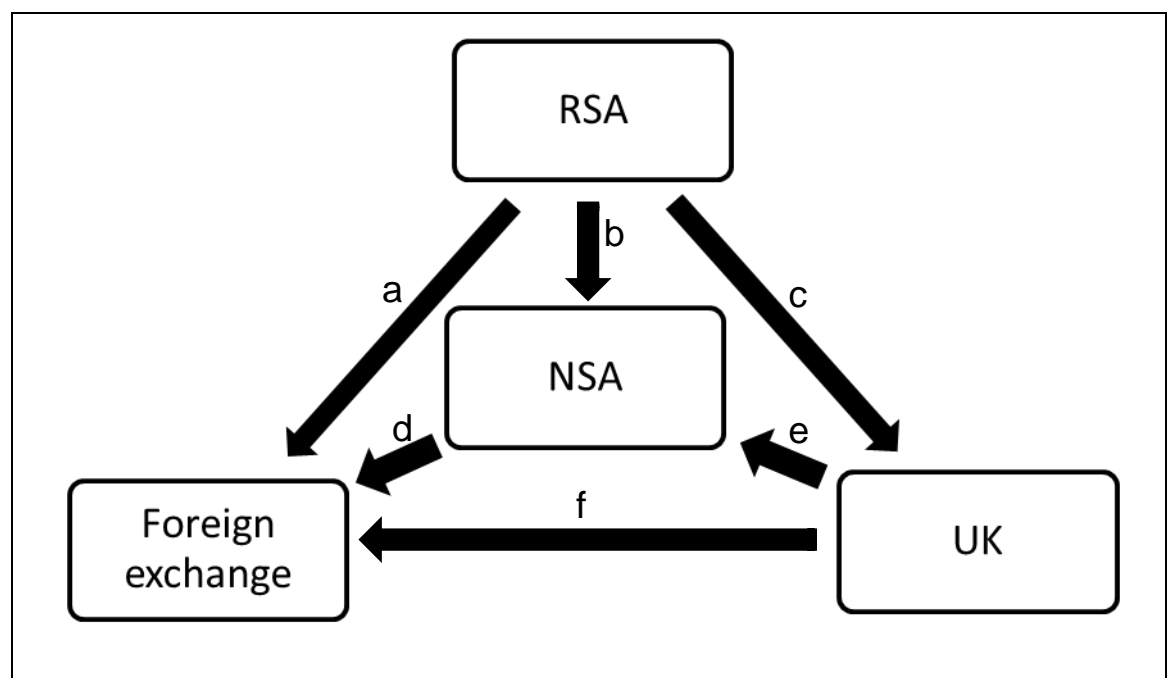


Figure 2: Flows of sterling associated with a change in the sterling balances of the RSA

Source: Author's illustration

Note: RSA = Rest of the sterling area; NSA = Non-sterling area

¹⁰⁴⁹ Section 3 for the BOE official view

The black arrows in Figure 2 are potential net sterling flows associated with a decline in the RSA's sterling balances over a given time period.¹⁰⁵⁰ The primary flows are named a, b and c. The second-order flows are labelled d, e and f. If the RSA's collective reserves (sterling balances) were to decline during a crisis by a given amount, that change would equal $a + b + c$. Some of this sterling would be spent acquiring US dollars for imports, also known as 'drawing on the sterling area's dollar pool' (arrow a). The sterling would be sold to the Bank of England or the London FX market: here, there was likely to be an immediate and direct negative impact on the UK's reserves. Arrows b and c, however, represent payments of sterling for goods, services or assets, so there is no immediate impact on the UK's reserves: rather, the impact depends on how that sterling is subsequently spent.

In the case of the NSA, it is reasonable to assume that actors in this group of countries would not hold onto new sterling acquired from the RSA: they did not treat sterling as their reserve currency, and in a sterling crisis they might wish to dispose of new sterling acquired and buy gold and US dollars. Most if not all flows of sterling (arising from the decline in the RSA's sterling balances) which were coming in to the NSA (arrows b and e) would thus go out along arrow d, with a consequent negative impact on the UK's reserves, as the Bank of England acted as sterling's buyer of last resort in the foreign exchange market. In some NSA countries, this FX settlement of sterling received was automatic, either through the Federal Reserve Bank of New York, which acted as FX agent of the Bank of England, or through the mechanism of the EPU in the 1950s.

¹⁰⁵⁰ The RSA here is a closed group of countries: sterling spent by Australia in New Zealand (both RSA countries) would not alter the RSA's overall sterling balances

The key residual uncertainty is the extent to which net flows of sterling from the RSA to the UK (arrow c) resulted in knock-on flows of sterling out of the UK (arrows e and f), bearing in mind that the UK was in very full employment in the 1950s-60s. For instance, sterling received in the UK for manufactured exports to the RSA might be partially spent on raw materials imports from the NSA. Or, less directly, it could be spent on wages fulfilling those export orders, and those wages in turn would be spent and in turn the incomes from those transactions might cumulatively leak out of the UK. It is worth recalling that the source of the UK's balance-of-payments problems of the 1950s-60s is thought to have been an excess of absorption over production, insufficient saving leading to inflationary pressure.¹⁰⁵¹ The flows through arrow c would only *not* lead to some knock-on flow through arrows e and f if *all* the sterling so received was saved in the UK.

The data in this paper does not provide information about the relative sizes of a, b, c, d, e and f. (Obtaining such monthly data would require a complex multi-country study).¹⁰⁵² The variables that are observable in this paper are the aggregate change in the RSA's sterling balances, and the simultaneous change in the UK's reserves. However, the different mental models of the critics and defenders of the sterling area system were evident in their different approaches to the flows. Defenders of the system, by focusing only on the RSA's balance of payments with the NSA, were concerned only with arrows a and b. There was an implicit assumption that all sterling received through arrow c was being saved in the UK, even while the crisis was being caused domestically by insufficient saving (an excess of absorption over production). As they argued, across the period as a whole (as opposed to crises), the combined flows a and b tended to be negative (the RSA was in surplus with the NSA).¹⁰⁵³ By

¹⁰⁵¹ Sinclair, 'The balance of payments', pp193-201; Paish, 'The sterling area crisis'

¹⁰⁵² IMF direction of trade statistics provide countries' annual visible imports and exports with other countries but this data does not have the balance-of-payments breadth or monthly granularity for a study of sterling crises

¹⁰⁵³ See Section 3

contrast, the critics were concerned about crisis periods, the overall balance of payments and knock-on effects such as inflation, sometimes assuming that the aggregate effect on UK reserves was $a + b + c$ (i.e. making no allowance for the possibility of *any* saving in the UK). The true effect on UK reserves lay, of course, somewhere between these two extremes, in the (unobservable) $a + d + f$. Which view was closer to the truth depended largely on how much sterling income (arising from the part of RSA outflows that went to the UK) was ultimately being saved.

In the literature of the 1950s and 1960s, one can observe the academic focus change from a singular concern with the dollar pool and the dollar area (arrow a),¹⁰⁵⁴ to (after the 1951-2 crisis) a broader consideration of the balance of payments with the NSA (arrows a and b),¹⁰⁵⁵ to the broadest emphasis on countries' overall balance of payments and knock-on effects (all the flows represented in Figure 2).¹⁰⁵⁶ The merits of the different accounting analyses for the 1950s were summarised by Scott in an article 'The balance of payments crises'. He discussed three different measures of the RSA's 'contribution' to the UK's 'overall' surplus or deficit requiring financing: (1) the RSA's surplus or deficit with the NSA (he said this implicitly assumed that 'bilateral surpluses or deficits between members of the sterling area do not affect the balance between the area and the rest of the world'), (2) the first measure plus the RSA's current deficit with the UK (he said this recognised that 'the United Kingdom's exports or imports from the R.S.A. substitute for exports to or imports from the non-sterling area'), and (3) the changes in the RSA's sterling balances (he said this reflected a 'responsibility of each member of the sterling area to ensure that its current and capital transactions with all other countries are kept in balance'). He argued that the appropriate measure might have progressed from the first to the second to the third during the 1950s, as the

¹⁰⁵⁴ Wright, 'Dollar pooling'

¹⁰⁵⁵ Stevens, 'Some notes'; Bhagat, 'Working'

¹⁰⁵⁶ See Kamarck, 'Pooling: comment'; Zupnick, 'The sterling area's'; Scott, 'What should be done'

systems of international settlements altered.¹⁰⁵⁷ We return to Scott's analysis in Section 6.

2.5 Kahn and the Kahn Reports

Richard Kahn (1905-89) was an eminent British economist based at Cambridge University, who worked closely with John Maynard Keynes. In 1994, a whole issue of the *Cambridge Journal of Economics* reviewed his lifetime contributions to economics. A self-styled 'disciple of Keynes', he was, according to some, a 'co-author' of Keynes's 1936 *General Theory* by virtue of his commentaries on Keynes's drafts and his own early (1931) exposition of the 'multiplier' which became a part of Keynesian analysis. The multiplier is a dynamic process through which autonomous exogenous expenditure (e.g. investment, or net foreign balance) successively feeds through endogenous spending iterations to a larger cumulative effect on aggregate demand.¹⁰⁵⁸ The knock-on flows involved in Figure 2 are one representation of such an effect.

Kahn also believed that economics should be applied to practical problems, and he worked as a consultant to the UK government. The 1964-70 Labour government asked him to review the causes of the sterling crises that engulfed their administration from their first days in office in 1964, and he completed this work, with help from the Bank of England, in the two aforementioned Kahn Reports published in 1966 and 1971.

What were Kahn's conclusions about these crises? He expressed the UK's vulnerability as follows:

'the imbalance between the short-term assets and the short-term liabilities
(and in particular from the use of sterling as a key currency) combined with a

¹⁰⁵⁷ Scott, 'The balance of payments', pp211-2

¹⁰⁵⁸ See Passinetti, 'Richard Kahn', Goodwin, 'Kahn' and other articles in the same journal issue

strong propensity to run into balance of payments deficit on current and long-term capital accounts taken together'.¹⁰⁵⁹

Kahn's principal recommendation was that the UK needed to address its balance of payments on current and long-term capital account.¹⁰⁶⁰ His reference to the capital account was a significant departure in UK official policy advice (which had previously focused on the need for a large current account surplus),¹⁰⁶¹ and it was relevant for the sterling area, which received the bulk of the UK's long-term capital flow.¹⁰⁶² Kahn's concern was not with the existence of the sterling balances themselves but with the fact that this borrowing was short-term. 'The vulnerability of the economy dictates a short-term view about overseas investment'.¹⁰⁶³ Kahn also highlighted exchange control weaknesses in the sterling area, and the need for some co-operation among sterling area countries at least during times of trouble.¹⁰⁶⁴

2.6 Kahn's methodology

Kahn's methodological approach in the Kahn Reports was to dissect, on a monthly basis, the UK's balance of payments into 'above the line' items (flows requiring financing) and 'below the line' items (flows providing the financing). Each crisis was characterised and precipitated by the actual loss of reserves to dangerously low levels. The UK government enjoyed some external support from the NSA, however, which mitigated the loss of reserves. The 'below the line' items were simply the change in reserves net of assistance received. Everything else was 'above the line'.

¹⁰⁵⁹ BOE:EID1/20, 'Enquiry' (1964-65) p1

¹⁰⁶⁰ BOE:EID1/20, 'Enquiry' (1964-65) pp109-11

¹⁰⁶¹ Tomlinson, *British macroeconomic policy*, pp58, 140

¹⁰⁶² In the 1950s and until the mid-1960s, the UK policy emphasis was on achieving a large enough current account surplus. The freedom of capital flow to the sterling area was untouched. For instance, it was not addressed in the 1961 crisis even though capital flow to the NSA was restricted (TNA:T267/34, 'Exchange control 1959/72', pp15-16, 59-60)

¹⁰⁶³ BOE:EID1/20, 'Enquiry' (1964-65) p111

¹⁰⁶⁴ BOE:EID1/20, 'Enquiry' (1964-65) pp94-105

In taking this approach, Kahn was diverging from the official presentation of the UK accounts and following more closely the precepts of the IMF, with its focus on autonomous flows and compensatory financing. The UK official 'standard' presentation consisted of the current account, the long-term capital account, the balance of monetary movements (which included reserves and assistance and was intended to represent changes in the net external liquidity position of the UK)¹⁰⁶⁵ and the balancing item (which represented residual unrecorded differences between the current and long-term account and the balance of monetary movements given their different sources – the balancing item ensured that the UK balance of payments summed to zero).¹⁰⁶⁶ Kahn was dealing with categories from the standard presentation (e.g. different components of the balance of monetary movements) but reordering them into reserves and assistance below the line, and other components above the line.

There are some obvious limitations to Kahn's simple methodological approach. There is, for instance, the problem referenced in the discussion around Figure 2: changes in the UK's net external sterling liabilities might not translate fully into changes in the UK's free reserves given the possibility of some saving in the UK.

There is another problem: what is autonomous and what is financing is much more nuanced in reality, across many components of the balance of payments.¹⁰⁶⁷ Thus a UK long-term capital outflow to the RSA, other things being equal, would result in a rise in the sterling balances of the RSA: the latter would finance the former. In Kahn's methodology, changes in the UK's net external sterling liabilities were autonomous (above the line) rather than financing (below the line). In the modern parlance of the IMF *Balance of Payments Textbook*, the sterling balances were 'liabilities constituting foreign authorities' reserves' (LCFARs), which are included (along with 'exceptional

¹⁰⁶⁵ For more on the balance of monetary movements, see Annex 1

¹⁰⁶⁶ For the standard presentation, see BEQB:1964Q4, pp276-86; for the balancing item, BEQB:1962Q1, pp16-22

¹⁰⁶⁷ BEQB:1964Q4, pp 276-86; 1968Q1, pp34-40

financing transactions' i.e. assistance) in 'Selected Supplementary Information', reflecting their *potential* financing role.¹⁰⁶⁸ In the 1960s, when considering how to apply the IMF's compensatory financing approach to the UK's balance of payments, the Bank of England argued that changes to the UK's net external sterling liabilities were financing (below the line), while admitting that this interpretation was open to debate.¹⁰⁶⁹

An example shows why the presentation mattered. If the focus was only on explaining changes in free reserves, the analysis might ignore periods in which a major problem in the UK current account was masked by short-term capital inflows. The year 1960 was a case in point. The UK's 'standard' approach revealed the 1960 problem, whereas the 'compensatory financing' approach focused on 1961 as the problem year, the year in which a reserve crisis occurred.¹⁰⁷⁰ The Bank of England argued that, due to the uncertainty of whether the movements were autonomous or financing, it was in fact 'impossible' to determine to what extent a change in the sterling balances might have led to a change in the UK's reserves.¹⁰⁷¹

On the other hand, it can be argued that Kahn's approach was appropriate to his task as a 'crisis detective', which was to hold all items of the balance of payments, other than those which were definitively financing, open to suspicion and analysis. The crisis was defined by reserves (the UK authorities did not optimise the UK's net external liquidity position, but they did monitor and seek to protect the gross reserves, as explained below). Assistance too clearly played a reactive, financing role. Thus it was in line with the IMF compensatory financing approach that the balancing item, which probably reflected statistical deficiencies in the compilation of the 'current and long-

¹⁰⁶⁸ IMF, *Balance of payments*, p34

¹⁰⁶⁹ BEQB:1964Q4, pp276-86

¹⁰⁷⁰ BEQB:1964Q4, p281

¹⁰⁷¹ BEQB:1968Q1, p37

term capital account' or 'miscellaneous capital' (e.g. trade credit), should be above the line.¹⁰⁷²

Finally, while it was true that some part of the change in the RSA's sterling balances might be financing some autonomous changes in the UK's balance of payments, it was also true that, ultimately, net changes in the RSA's sterling balances were autonomous, to the extent that they were themselves the financing (reserves) counterpart of the autonomous flows in the RSA's balance of payments. Kahn's approach was therefore arguably consistent with the modern IMF approach to the balance of payments. In the modern approach, LCFARs *can* be 'grouped together with reserve assets and exceptional financing as below-the-line items', but 'their relationship to reserve assets is not always clear'.¹⁰⁷³ The crucial test of such 'reserve-related liabilities' is that they are 'liabilities substituting for reserve assets'.¹⁰⁷⁴

Exceptional financing (assistance) certainly substituted for reserve assets, but movements in the sterling balances were neither controllable nor predictable, being autonomously driven by the RSA's balance of payments, and so practically could not substitute for UK reserves.

In order to illustrate his methodology, Table 2 summarises Kahn's calculation of the influences on UK reserves in the period October 1964-September 1965. Those items marked with an asterisk are the monthly data inputs used in this paper:

¹⁰⁷² BEQB:1968Q1, p38; 1964Q4, pp276-86

¹⁰⁷³ IMF, *Balance of payments*, p133

¹⁰⁷⁴ IMF, *Balance of payments*, p132

Movement over period:	£m	£m
Balance of current and long-term capital transactions	-521	
Balancing item	-12	
Net external liabilities in sterling to RSA countries*	-184	
Net external liabilities in sterling to NSA countries (excluding assistance)*	-437	
Net external liabilities in NSA currencies (excluding assistance)	-82	
Other monetary movements	-25	
Total spot financing requirement		-1261
Assistance etc*	-1277	
Reserves*	+16	
Total spot financing		-1261
Support of forward market by the Exchange Equalisation Account		-838
Total spot financing and forward support		-2099

Table 2: UK balance-of-payments items, extracted from first Kahn Report, October 1964 – September 1965, (£m)

Source: Extracted from BOE, EID1/20, Kahn, 'Enquiry into the position of sterling 1964-65', 1 Jun 1966, Table 1 p29. Asterisks are author's additions, see text

Note: Kahn estimated that the UK's identified balance of current and long-term capital transactions may have been £100-150m worse than otherwise due to confidence movements (UK capital flight), and the balancing item may have been £50m worse than otherwise due to leads and lags (idem, p31); and net external liabilities in sterling to RSA countries were lower than otherwise by £80m due to confidence movements (idem, p30)

2.7 Methodology of this paper

Before discussing Table 2 in more detail, it is necessary to consider the aims and methodology of this paper. The aim here is to explore the potential connections between changes in the sterling balances of the NSA and the RSA, and adverse changes in the UK's free reserves (reserves net of assistance), which defined the crises of the 1950s-60s. The investigation involves a simulation of Kahn's methodology outside his sample period of 1964-8, but, given the different aim, it does not need to consider individually, as Kahn did, the unasterisked items in Table 2, which can be lumped together as a residual. This is fortunate, because such monthly data is not readily available, so the residual is calculated using the knowledge that the UK's balance of payments (the known asterisked items plus the residual unasterisked items) sums to zero. Whenever a residual is mentioned, economists naturally become suspicious, but it must be emphasised that the asterisked items of Table 2 were by far the most precise and certain elements of the UK balance of payments¹⁰⁷⁵ – the items in

¹⁰⁷⁵ BEQB:1962Q1, pp19-20; 1968Q1, pp34-5

which the Bank of England had confidence – so it is indeed appropriate to calculate ‘everything else’ as a residual in the balance-of-payments accounting identity.

Where care must be exercised, however, is in trying to interpret the residual. In addition to fundamental factors within the UK’s balance of current and long-term capital transactions, it contains significant confidence movements, as is indicated by the Notes to Table 2, such as capital flight out of the UK (especially to the RSA given the lack of exchange control on such movement)¹⁰⁷⁶ and leads and lags.¹⁰⁷⁷

Since we are, in effect, extending Kahn’s methodology to the crises of 1951-61, it should also be noted that some of the items Kahn was concerned with were quantitatively not so important in these earlier years. One of these was the authorities’ activity in the forward markets (see Table 2). Only the spot financing position is considered in this paper. This is appropriate since the focus of this study is more on fundamental than confidence factors, and the connection between forward intervention and spot losses of reserves is uncertain.¹⁰⁷⁸ Another such item was net external liabilities in NSA currencies (see Table 2), which arose from the increased activity in the eurocurrency markets in the 1960s. This item was also affected by confidence influences and relative interest rates. It was quantitatively much smaller in the 1950s and is here subsumed within the residual.¹⁰⁷⁹

To summarise, we are taking as inputs observable monthly data (published reserves, sterling balances and assistance given to the UK by the NSA). The methodology relies

¹⁰⁷⁶ There was, for instance, significant capital flight from the UK to Australia in 1966-8. See Australia paper

¹⁰⁷⁷ ‘Leads and lags’ were a form of speculative short-term capital flow, caused by accelerated or delayed payment for goods subject to international trade. Being hard to spot, they were often associated with the balancing item (see Annex 1)

¹⁰⁷⁸ Forward intervention by the BOE was a major feature of the 1964-7 period but less so of earlier years (Capie, *Bank of England*, p206; Klug and Smith, ‘Suez and sterling’, p189)

¹⁰⁷⁹ Total net external liabilities in NSA currencies were small and static before the advent of the eurocurrency markets. In 1955 such liabilities stood at around £50m, by end-1957 about £70m, by 1961 approaching £800m and by 1964 they had reached £1,300m (BEQB:1964Q2, pp100-2)

on the fact that all these inputs are components of the UK balance of payments, and, moreover, the UK balance of payments automatically sums to zero.¹⁰⁸⁰ It is thus possible to re-order the monthly data as follows:

Change in the UK's published gold and convertible currency reserves
• <i>less</i>
Net assistance provided to the UK by the non-sterling area during the period
• <i>equals</i>
Change in sterling balances attributable to the wider sterling area
• <i>plus</i>
Change in sterling balances attributable to the rest of the world (non-sterling area), less all such change associated with assistance provided to the UK by the non-sterling area
• <i>plus</i>
Residual: all other elements of the UK balance of payments e.g. UK balance of payments on current and long-term capital account

Despite the Bank of England's aforementioned public reluctance to assign causal connections from the sterling balances to reserves, this reordering is at least broadly consistent with its own evaluation of the influences on reserves in this period:

‘what, in fact, finally determines movements in the reserves is the balance of all transactions on current and long-term capital account, taken in conjunction with the willingness, or otherwise, of overseas residents to hold part of their short-term external assets in sterling.’¹⁰⁸¹

The top two boxes taken together constitute the scale of the crisis, which is the variable that has to be explained. The duration of each crisis is defined by continuous

¹⁰⁸⁰ See BEQB:1968Q1, pp34-40; also for an explanation of the UK balance of payments, Thirlwall and Gibson, *Balance-of-payments theory*, pp38-50 and in particular Table 2.1, ‘Transactions in external liabilities’ on p39

¹⁰⁸¹ BEQB:1968Q1, p37

monthly declines in this variable, a downward peak-to-trough movement in published reserves after deducting net assistance to the UK from the NSA. (For shorthand, published reserves so adjusted are now called ‘adjusted reserves’. The change in adjusted reserves over the duration of the crisis is the scale of the crisis).¹⁰⁸² It must be acknowledged that focus only on crisis periods is incomplete analysis as it misses the non-crisis periods. Nevertheless, many past economic studies have looked at crisis periods in isolation, and these crises were a large part of the UK’s perceived balance-of-payments problem.

The bottom three boxes represent the three regional contributors to the scale of each crisis, namely the wider sterling area, the rest of the world, and the UK. The concern, given all the many autonomous and financing flows in various directions, is whether these three quantities truly reflected these regions’ respective fundamental contribution to the loss of adjusted reserves during crises.

The penultimate box, the rest of the world’s contribution to crisis, is assumed to be largely a confidence movement. Why so? Firstly, assistance by the NSA to the UK has been deducted. Secondly, as will be shown,¹⁰⁸³ countries in the NSA were not typically using sterling as a transactional reserve that moved with their fundamental balance of payments. This would have been particularly true during crises, when the NSA’s sterling balances were declining in response to the crisis. What remains, therefore, is

¹⁰⁸² The rationale for this approach to crisis duration is as follows. As already noted, sterling crises in these years consisted of a rapid decline in UK reserves culminating in a major policy reversal. The trigger for such a policy shift was the published reserves reaching a perceived danger level, widely known to be around US\$2 billion (= £714m at £1 = US\$2.80) (see Boughton, ‘Northwest of Suez’, p445; Klug and Smith, ‘Suez and sterling’, pp192-3). It makes sense to focus on a continuous downward move in the adjusted reserves, since the crisis was not over until the adjusted reserves had stopped declining. The adoption of this approach means that the crisis periods in the 1964-7 years are different from those surveyed by Kahn. For example, the incoming Labour government’s brief for Kahn’s first report dictated his starting point in Oct/1964, but in fact adjusted reserves were declining from mid-1964. It also means that the crisis periods in the 1950s differ from those in the existing literature, where there is no consistency and usually little justification given for crisis dates. Consider the crisis dates given by Hirsch (Jul/1951-Apr/1952, Jul-Sep/1955, Aug-Dec/1956) (Hirsch, *The pound sterling*, pp48-9) against those by Klug and Smith (Sep/1951-Jan/1952, Jul-Dec/1955, 26Jul-7Dec/1956) (Klug and Smith, ‘Suez and sterling’, p193)

¹⁰⁸³ See Section 6 and Annex 4

confidence, and confidence movements are usually a response to vulnerability rather than a cause.¹⁰⁸⁴

The key issue is whether the change in the RSA's sterling balances (the third box) can be argued to have had a full contributory effect on the change in the UK's adjusted reserves. In two ways, the effect can be said to be exaggerated. Firstly, there was the analysis of Figure 2 – some part of the associated sterling flow to the UK (which was one of three possible flows arising from a decline in RSA sterling balances) might have been saved in the UK rather than leading to knock-on external spending. Secondly, the change in the RSA's sterling balances may have been affected by RSA diversification of reserves (selling sterling to retain gold and dollars instead) if we now drop the assumption that the RSA only used sterling as its reserves. Such diversification can be interpreted as a confidence-driven reaction to crisis. However, anticipating the findings of Section 6, such diversification by the RSA was very limited prior to 1964: unlike for the NSA, the RSA's sterling balances movement before 1964 was fundamental rather than confidence-driven.

Against this theoretical overstatement of the reserves effect of a change in the RSA's sterling balances, however, there is a significant argument for understatement. It should be borne in mind that the residual in the bottom box includes a large annual long-term capital flow from the UK to the RSA,¹⁰⁸⁵ it includes significant confidence movements out of the UK during crises, such as leads and lags and other forms of capital flight, and it excludes all assistance to the UK from the NSA. On the other hand, the changes in the sterling balances of the wider sterling area include a large annual long-term capital flow to the RSA from the UK, they include significant confidence movements from the UK to the RSA during crises, and they include all assistance to

¹⁰⁸⁴ 'Self-fulfilling crises' being the main exception

¹⁰⁸⁵ Around £200m per annum. See Annex 5

the RSA from the NSA.¹⁰⁸⁶ Since the aim is to isolate fundamental drivers of a decline in adjusted reserves, this constitutes a bias towards positive movement in sterling balances in the wider sterling area (and negative movement in the residual) during sterling crises.¹⁰⁸⁷ A (qualitative) evaluation of the components of any change in the RSA's sterling balances during sterling crises (dividing these into fundamentals, confidence and assistance) is reserved until Section 6. The raw figures are presented in Section 5.

2.8 Data quality and sources

The paper makes use of a mixture of existing and new primary data. The monthly sterling balance data come from a published source¹⁰⁸⁸ and two sets of files at the Bank of England Archive. The first archival source, the Overseas Negotiation Committee (ONC) reports, covering the years 1949-58, was used by Schenk in a ground-breaking sterling area study in the early 1990s.¹⁰⁸⁹ In addition to the sterling holdings referenced by Schenk, these reports are also rich in other balance-of-payments information, such as credit assistance to the UK e.g. from the European Payments Union (EPU). The second source, the reports of the Committee for Overseas Figures (COF), has not hitherto been referenced by the literature and covers the period 1957-68. The monthly reporting of country sterling balances in 1957-68 coincides with the earliest monthly reporting of official reserves in the IMF online database, and a comparison indicates the monthly operational reserve management of sterling area and other countries during this period.¹⁰⁹⁰

¹⁰⁸⁶ Section 6 shows that, unlike 1964-7, the sterling balances of the RSA were not subject to significant negative confidence movements during 1951-61 (which would normally have been reflected in increased non-sterling reserves) so there is no mitigation from this source. For example, with reference to the 1957 crisis, the BOE estimated that there was a £50 million negative confidence element in the UK balance of payments, but no negative confidence element in the RSA sterling balances (BOE:EID16/8, '...1957, 1961 and 1964/65 Crises', 'Table III...Confidence Movements', 12/1/1966)

¹⁰⁸⁷ This can be seen most clearly in the 1961 crisis, where the RSA's sterling balances increased, but this was partly due to a significant IMF drawing by Australia in Apr/1961 (assistance from NSA to RSA)

¹⁰⁸⁸ BOE:Statistical Abstract No.1, 1970

¹⁰⁸⁹ Schenk, *Britain*, p20

¹⁰⁹⁰ Examples shown in Annex 4

Data quality issues need to be considered. In general, the reserves and sterling balances were much the most reliable elements of the UK's balance of payments.¹⁰⁹¹ There are no problems with the UK's gold and convertible currency reserves (except that there were, as will be seen, also some 'unofficial' investments held outside the reserves). But the sterling balances, either published by the Bank of England or contained in its ONC and COF reports, require careful handling. In addition, the measurement of varied types of assistance, collected from a range of UK archival sources, was the hardest part of the data collection, and also involved judgements about selection.

The sterling balances were reported monthly but figures were subject to frequent revisions. There were country departures from the RSA, and also occasional general changes of series definition, a major revision occurring in 1962. Calculating net external liabilities meant ensuring that claims were deducted from gross liabilities, but the claims and the net liabilities position are not always accessible at the individual country level in the 1958-62 years. There are also files missing from the COF reports, particularly a run of files covering much of the 1964-6 crisis period, which were probably removed for analysis by Kahn or his team, and not returned.¹⁰⁹² To ensure consistent treatment of the sterling balances data, they have been examined in three separate periods. The first, from December 1949 to December 1958, uses the ONC reports. The second, from December 1958 to December 1962, uses published data and the COF reports up to the point of the major sterling balances definition revision.

¹⁰⁹¹ BEQB:1968Q1, pp34-40

¹⁰⁹² This does not matter for the purposes of this paper, since we already have Kahn's and Capie's calculations for assistance, and a run of published sterling balances data for the 1962-7 years, and there is no need for an 'exiter' country adjustment to the RSA's balances in this period. But the data gap affects graphs such as those shown in Annex 4

The third, from December 1962 to December 1967, mainly uses published data and reflects the new post-1962 series.¹⁰⁹³

The paper adopts two noteworthy policies towards the data. Firstly, there is an adjustment to be made to the sterling balances. The RSA is taken also to include a few countries which had exited the sterling area, and whose sterling balances were consequently still in run-off and had not reached a level consistent with other NSA countries. This might at first seem controversial, but it is the correct approach, because the sterling balances of these 'exiters' had arisen through their membership of the sterling area, and the run-off was a known problem facing the sterling area as a co-operative system. The balances of relevant countries are deducted from the NSA balances and added to the RSA balances.¹⁰⁹⁴ The quantitative effects of this adjustment do not alter the broad findings about the crises, as is apparent from Section 6.

Secondly, for the 1950-8 years, the paper adopts a different treatment of 'assistance' than did Kahn. When using this term, Kahn (and subsequently Capie) were talking about UK official short- and medium-term borrowing from outside the sterling area, amounts which would have to be repaid in short order.¹⁰⁹⁵ In the absence of more evidence about assistance in the 1958-62 years, the same approach is undertaken for the 1961 crisis. However, in the 1950s, the UK was also receiving significant grants and long-term loans from the NSA.¹⁰⁹⁶ Since the aim is to estimate, roughly, the scale of each crisis and the UK's standalone balance-of-payments contribution to each crisis against that of the RSA, it seems appropriate also to include, within assistance, all

¹⁰⁹³ While this paper is primarily looking at the behaviour of sterling balances during specific sterling crises, it is also informative to review trends in RSA and NSA sterling balances during these three periods

¹⁰⁹⁴ The relevant countries are Egypt, Sudan and Palestine/Israel in the 1950-8 period; and Egypt and Iraq in the 1958-62 years. In 1962-7, while there were notable exiters from the sterling area, Burma and Southern Rhodesia, they had already reduced their sterling holdings to a low level prior to leaving the area so there is no need for this adjustment to be made

¹⁰⁹⁵ Capie, *Bank of England*, pp227-35. Kahn ignored other types of assistance such as a 'bisque' (capitalised long-term deferral of interest) allowed by the USA in Dec/1964 (see Annex 2)

¹⁰⁹⁶ Uniquely in the 1950-8 years, this additional data is accessible

grants and long-term loans (those which had an assistance motivation) as well. There were two broad types of assistance, one type matched by a net external liability in sterling to the NSA, and another not matched by sterling liabilities. The former type needs to be deducted from the NSA sterling balances, as indicated in Table 2. Each category of assistance is discussed in Section 4. Before proceeding to this, however, the next Section provides the principal ‘defender’s’ view, the Bank of England’s public and private statements on the connections between sterling balances and reserves.

Section 3: the Bank of England view – public and private

This Section considers the Bank of England view, as a principal public defender of the sterling area system. The public attitude of the Bank of England to the (aggregate) sterling balances throughout the period is summarised in a speech given by the Governor to the Overseas Bankers Club on 30 January 1967.

‘These balances are not the United Kingdom’s main problem. They do, of course, represent very large liquid liabilities but they have been extraordinarily stable since the war... No-one can deny that running a reserve and international trading currency is not made any easier when our gold and foreign exchange reserves are not as large as we should like but our difficulties in this respect have been caused entirely by our own inadequate performance in the balance of payments field. As this performance improves, which we are confident it will during 1967 and thereafter, the problem will recede.’¹⁰⁹⁷

These themes were expounded in more detail in a document, ‘The sterling balances’, sent by the Foreign Office to overseas missions in December 1966, which, given its statistical backing, was almost certainly drawn up by the Bank.¹⁰⁹⁸ It claimed to be ‘a factual examination’ of the balances but understandably presented a defender’s point of view. Again, it reflected that the sterling balances were ‘remarkably stable’, but admitted that short-term movements in the balances were ‘quite large enough to cause strain on the reserves at particular periods’. The memorandum referred to each of the prior crises, highlighting the declines in sterling balances and their causes (see Table 3).

¹⁰⁹⁷ BEQB:1967Q1, p58

¹⁰⁹⁸ BOE:EID10/25, ‘The Sterling Balances’, 9/12/1966

Crisis	Stated cause of sterling balance movement leading to UK reserve strain
1951-2	Korean War and its aftermath: reductions follow corresponding increase
1955	Sizeable UK balance-of-payments deficit in that year
1956	Uncertainties connected with Suez
1957	Partly concern about UK wage costs and prices; partly RSA deficits
1961	Weakening of confidence caused primarily by large UK deficit in 1960
1964-5	Sharp loss of confidence following huge UK deficit (plus much smaller RSA deficits)

Table 3: UK government explanation for declines in sterling balances during crisis periods, 1951-65

Source: BOE:EID10/25, 'The Sterling Balances', 9/12/1966, sent by the Foreign Office and Commonwealth Office to 'certain overseas missions'

Note: Sterling balances = net external liabilities of the UK in sterling

As is evident from Table 3, this document largely attributed sterling balance changes to confidence movements in reaction to UK weaknesses (e.g. the UK balance of payments, Suez, UK inflation), downplaying RSA deficits. In response to a contemporary French government claim that RSA deficits destabilised sterling, the document argued that RSA deficits 'only cause direct pressure on sterling when the deficits are with NSA countries' and that such occasions were rare and the deficits small relative to those of the UK with the NSA. A third longer-term argument in support of sterling's solid international position was that 'sterling is both a reserve and a trading currency... reserve holdings have not fallen very much. Traders' holdings have risen a great deal'.¹⁰⁹⁹

Against this public expression of confidence, the Bank's archives provide evidence of some of its officials' private concerns about the link between sterling balances and UK reserves. These became most evident during the 1956 working party which reviewed the sterling area. In a paper written in April 1957, the adviser Thompson-McCausland observed: 'every substantial fall in the external sterling holdings has meant a broadly equivalent fall in the U.K.'s reserves'. The statement was accompanied by a graph of

¹⁰⁹⁹ In making this claim, the document equated traders' holdings with private holdings of sterling held outside central monetary institutions (then over £1,500m): however, as the Ireland and Australia chapters showed, private holdings of sterling were often monetary reserves of commercial banks (designated official reserves in Ireland and held as agents of the central bank in Australia), not an expression of traders' confidence in sterling. The BOE made the same claim (that stable, increasing non-official holdings demonstrated the confidence of private traders in sterling as a commercial currency) in other documents (e.g. BEQB:1963Q4, pp264-78)

sterling balances and UK reserves between 1950 and 1957 which indeed showed this to be the case.¹¹⁰⁰

The same graph tracking UK 'reserves of gold and convertible currencies' against 'overseas sterling holdings' became a regular up-front item of the internal COF reports which began in 1957. The singular graph, which appeared monthly, was only dropped from the report in 1963.¹¹⁰¹ The Bank's Statistics office, responding to the Deputy Governor's query about a similar graph in 1956, noted the 'high degree of correlation between the two lines' and explained it in balance-of-payments accounting terms. The paper observed that the UK's current account surplus and overseas investment flow had been similar in scale since 1949 (these variables tending to offset each other) and in these circumstances, the change in sterling balances and change in reserves were also similar, since these two differences were automatically equal to each other through the balance-of-payments identity.¹¹⁰² This was another way of saying that the balance on current and long-term capital account is roughly equal and opposite to the balance of monetary movements in the official 'standard' presentation.¹¹⁰³ In a 1965 review, Bank analysts also highlighted the important role of the sterling balances in the crisis of 1957.¹¹⁰⁴ This paper's findings, regarding the correlation between sterling balances and reserves, are discussed in Section 5.

As for the question about the correct balance-of-payments metric for the UK and RSA (the overall balance or the balance versus the NSA), the NSA metric was often used in Commonwealth financial conferences. But interestingly British policy was framed in terms of the overall current account, not the balance with the NSA.¹¹⁰⁵ The view that

¹¹⁰⁰ BOE:OV44/33, Draft, 'The sterling area', Thompson-McCausland, 10/4/1957

¹¹⁰¹ No explanation for the dropping of the graph could be found

¹¹⁰² BOE:EID3/114, 'Correlation between movements...', Statistics office, for Deputy Governor, 6/2/1956

¹¹⁰³ Changes in reserves and the sterling balances being the main items in the balance of monetary movements

¹¹⁰⁴ BOE:EID16/8, '...1957, 1961 and 1964/65 Crises', 12/1/1966

¹¹⁰⁵ Tomlinson, *British macroeconomic policy*, p58

the overall balance was relevant was also concluded by Commonwealth officials in a report about the sterling area's balance of payments in 1955:

*'The Overall Balance and the Non-Sterling Balance... it would be a misapprehension to regard the sterling and non-sterling balances of any particular country as being in separate compartments... an estimation of the overall balances of the sterling area countries is essential to the analysis of the causative factors influencing the non-sterling position of the sterling area as a whole.'*¹¹⁰⁶

Thus contemporary officials were at least aware of the indirect pressure that RSA deficits with the UK might pose for the UK reserves. There is a logical problem with ignoring all the UK-RSA trade and other flows shown in Figure 1.¹¹⁰⁷ The RSA was not a featherbed for the UK's exports:¹¹⁰⁸ the UK's net exports to the sterling area engaged real UK resources with genuine alternative uses. If so, those UK export resources had value and could theoretically have been redeployed in other directions. Still, as already noted, different contemporary analysts had different mental models and took different approaches.

Kahn and the Bank would have been uneasy collaborators in the Kahn Reports. The UK officials who had to defend the sterling area, and who had responsibility for it from the mid-1950s until 1968, Rickett in the Treasury, and Parsons and Bridge at the Bank,¹¹⁰⁹ do not appear to have been set on changing the system to any great extent. When Kahn's 1966 Report proposed a target of reducing the short-term liabilities

¹¹⁰⁶ NAA:A1838,708/13/4PART1,553815, 'Sterling Area balance of payments...', 19/12/1955. Note that the word 'balances' in this citation means, not sterling holdings, but 'balance of payments'

¹¹⁰⁷ As argued in Scott, 'The balance of payments', pp211-2

¹¹⁰⁸ As argued in Schenk, *Britain*, pp54-87

¹¹⁰⁹ Denis Rickett, Maurice Parsons, Roy Bridge. Rickett was head of Overseas Finance in the Treasury and listed third in importance after the Chancellor and head of the Treasury William Armstrong in the Treasury address list for the first Kahn Report. Jenkins described him as 'the last of the old-style Treasury mandarins' (Jenkins, *A life*, p242). For Parsons and Bridge see Capie, *Bank of England*, pp403-5

represented by the sterling balances by £600m, the Bank's internal response was negative towards such a change in policy: 'any surplus available would be better held in the reserves because this would improve the assets/liabilities ratio'.¹¹¹⁰ There was not much suggestion here of a desire to reduce sterling's international role. And Kahn, in his turn, in the 1971 report was critical of the evolution of policy at the Treasury (and implicitly the Bank): he complained of Overseas Finance 'mystique' and 'a somewhat "closed shop" and traditionalist attitude, sceptical of any contribution from external disciplines'.¹¹¹¹

¹¹¹⁰ BOE:G1/497, 'The Kahn Report', 30/6/1966

¹¹¹¹ BOE:EID1/7, 'Enquiry' (1966-68, Vol.II), 12/8/1971, p192

Section 4: Assistance and the scale of sterling crises, 1951-67

This Section reviews assistance to the UK from the NSA, indicates its role in the NSA sterling balances, and shows the consequent scale of each of the crises of the period through movements of the adjusted reserves. From the work of Kahn and Capie, assistance (short- and medium-term borrowing from the NSA by the UK) has already been established for the 1964-7 period. A similar approach is undertaken for the 1961 crisis. But assistance during the 1950-8 years is handled differently, because it consisted principally of grants and long-term loans, which are accessible to the researcher. Table 4 shows two types of assistance during this period, one matched by changes in sterling balances, and the other received without changing the sterling balances.

Types of assistance received by the UK (1950-8)	
Matched by changes in sterling balances	Not matched by changes in sterling balances
IMF drawing (1956) Pre-quota EPU (1950+) New EPU credit (1951-8) West Germany support (1956-8)	USA – ERP (Marshall Plan Aid) (1950-1) USA – Mutual Defence Aid (1951-8) EPU – initial debit balance (1950)* EPU – Katz-Gaitskell Agreement (1950-1) Last drawings on Canada 1946 loan (1950) Debt service, USA/Canada 1946 loans (1951-8)* USA 1946 loan service deferral (1956-7) USA Export-Import Bank loan (1957) Bank of England window-dressing (1956) *indicates negative assistance

Table 4: Types of assistance received by the UK from the NSA, 31 December 1949 – 31 December 1958

Source: for left hand side, see sources in Figure 3; for right hand side, see Annex 2

Note: ERP = European Recovery Program, EPU = European Payments Union, NSA = Non-sterling area

Table 4 shows the complexity of assistance. The types of assistance on the right hand side of the Table (ERP, Defence Aid, loan service deferral and the Export-Import Bank loan being the four largest items) are explained in more detail in Annex 2.¹¹¹² In order

¹¹¹² The most difficult judgements for these items were how to treat debt service on the American and Canadian 1946 loans and the BOE's window-dressing (essentially short-term borrowing in New York). The 1946 loans were clearly assistance to the UK (they were long-term, low interest loans and interest-free until 1951), and so it is logical to treat the debt service on these loans as negative assistance: the debt service was a known liability for the sterling area as a co-operative system. See Annex 2

to indicate the role of assistance matched by changes in the sterling balances, the discussion now focuses on the three European types of assistance on the left hand side of the table, and their effect on the sterling balances of the NSA countries.¹¹¹³

The EPU (1950-8) was a credit mechanism designed to encourage the provision of multilateral credit in Europe. There were two sorts of sterling holding associated with the EPU. The first, known as the pre-quota EPU holdings or 'existing resources', were liabilities which the UK already owed to specific EPU members at the start of the EPU, and were settled during the 1950s. The second was the new credit extended to the UK during the operation of the EPU.¹¹¹⁴ Thirdly, by agreement with the UK, West Germany from 1956 began to support the UK with sterling holdings in excess of its EPU holdings, in anticipation of redeeming its post-war obligations to the UK. These increased sterling holdings were helpful to the UK during the 1957 crisis.¹¹¹⁵

The NSA country sterling holdings in 1950-8 also included a large element representing the holdings of Egypt, Sudan¹¹¹⁶ and Palestine/Israel, all of which had exited the sterling area during the late 1940s, but where the run-down of balances during the 1950s was anticipated and partially controlled. Since these holdings were a hangover from these countries' membership of the sterling area, it is appropriate that they should be included with the RSA rather than with the NSA.

After deducting all these different credit and sterling area elements, the remaining net external liabilities of the UK to the NSA countries, which, following Kahn, may be

¹¹¹³ The IMF drawing in 1956 was a one-off form of assistance and not from a country. It is relatively straightforward and including it in the discussion would not be enlightening

¹¹¹⁴ Deficits in the EPU, although settled in credit or gold with the UK, reflected the trading of the sterling area as a whole with EPU countries. There was also a one month settlement delay, so the credit extended to the UK included the credit outstanding at that month plus the deficit for that month

¹¹¹⁵ The support particularly arose out of a UK-West Germany agreement to offset West Germany's war-related obligations to the UK under the 1953 London Agreement against the UK's obligations to West Germany under EPU. The German central bank placed a £75 million deposit at the BOE in 1957 (TNA:FO371/128293)

¹¹¹⁶ Sudan was even described as being a 'de facto' member and mooted to re-join the sterling area upon its independence in 1956 (BOE,OV134/2, 'Redemption...', Johnston to Armstrong, 15/1/1957)

assumed to be a barometer of NSA confidence in sterling, were much lower than they appeared to be in aggregate. This puts quite a dent in sterling's claim to be a willingly held reserve currency outside the sterling area in the 1950s. The decomposition is shown in Figure 3, in which the residual NSA holding is displayed in black and named 'NSA confidence'.¹¹¹⁷

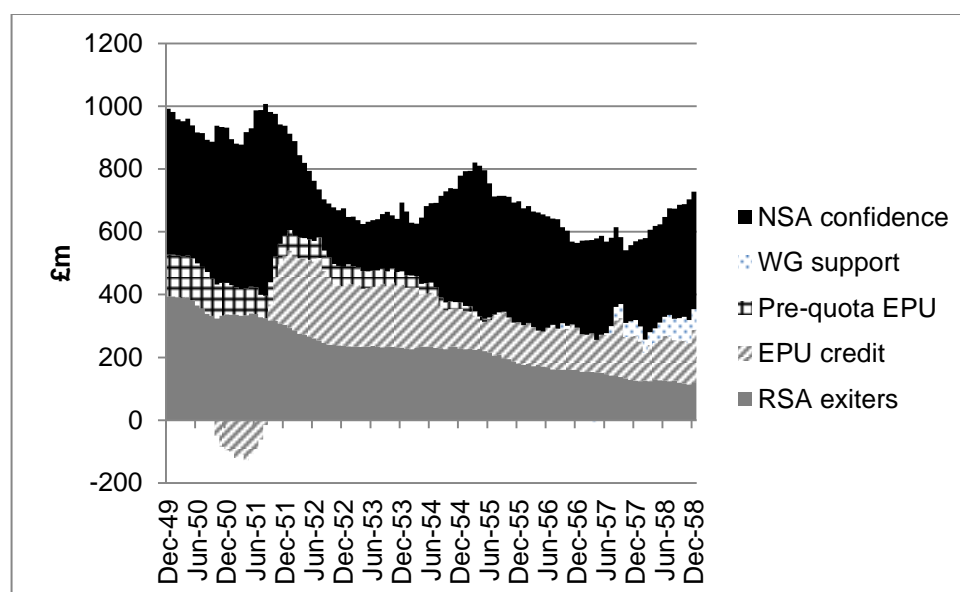


Figure 3: Decomposition of sterling balances of NSA countries, monthly at end-month, December 1949 – December 1958 (£m)

Source: Calculated from BOE:EID3/98–EID3/106 and, for EPU, also from TNA:T232/394–T232/412

Note: RSA exitters = Egypt, Sudan, Palestine/Israel; EPU = European Payments Union; WG = West Germany; RSA = Rest of the sterling area; NSA = Non-sterling area; Sterling balances = Net external liabilities of the UK in sterling. NSA confidence is derived as a residual after deducting the four other elements, where positive, from the total sterling balances (the UK's net external liabilities in sterling) of the non-sterling area countries. The non-sterling area figures shown are only for countries and do not include international organisations such as the IMF, which are treated separately in the analysis. The pre-quota EPU balances shown as existing resources at the beginning of the EPU in July 1950 are assumed to have been the same in the preceding months. Note that the negative EPU credit in 1950-1 (the UK started with an initial debit balance and at first benefited from sterling area surpluses in the EPU) was not matched by sterling balances

With the calculation of assistance, the scale of the crises (declines in adjusted

reserves) can now be revealed. For the crises of 1964-7, Capie has already presented

¹¹¹⁷ Schenk provided a line-graph of NSA sterling balances (without the decomposition), based on the same data, which looks different from Figure 3. The differences are attributable to various factors. Firstly, this graph uses monthly rather than quarterly plots. Secondly, this graph does not include the sterling balances of international organisations such as the IMF. Thirdly, this graph adjusts for a series revision in 1956 which reduced the NSA country sterling balances by £82m: the pre-revision balances are diminished by £82m. Fourthly, Schenk's graph has three surprisingly low plots (Dec/1953, Dec/1954, Dec/1955) which I could not find in the source data. Fifthly, there may also be minor single digit differences arising from different treatment of revisions. See Schenk, *Britain*, Figure 2.2, p21

the transition from published to free reserves (after deducting assistance).¹¹¹⁸ In Figure 4, the crisis periods for 1964-7 have therefore been taken from the peak to the trough (in month 0) of free reserves, using Capie's figures converted into pounds sterling at £1 = US\$2.80.¹¹¹⁹ Figure 4 shows the UK's state of near-insolvency by mid-1966.

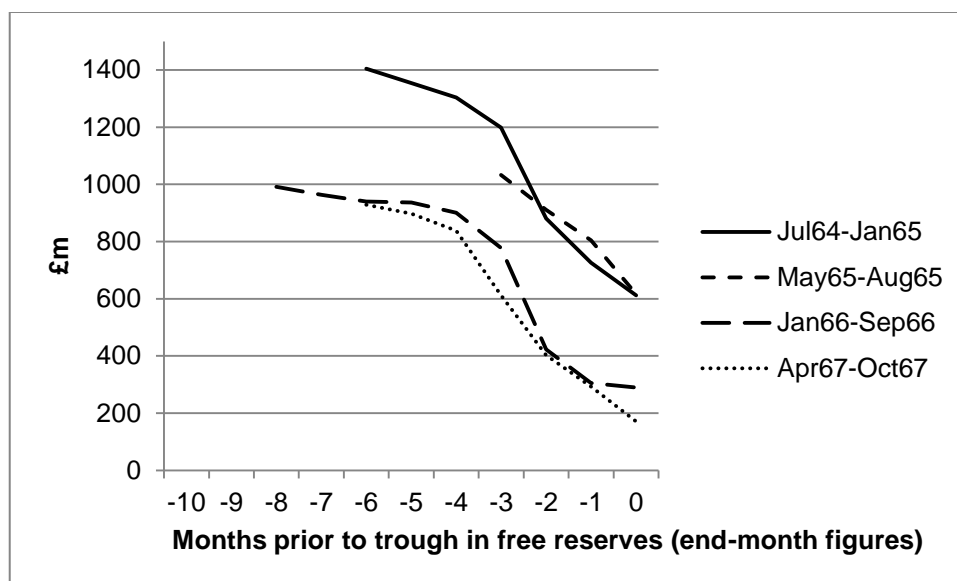


Figure 4: 'Free reserves' during sterling crises, monthly at end-month, July 1964 – October 1967 (£m)

Source: Capie, *Bank of England*, Table 5.1, Column (7), pp231-2, converted into sterling at £1 = US\$2.80

The scale of the 1951-61 crises can now also be estimated. Since, for the 1950-58 period, we have been including grants and long-term loans in assistance, 'free reserves' cannot be defined (grants are not a claim on the reserves). Figure 5 therefore shows the crises of 1951-61 in terms of what would have happened to published reserves if assistance had not been received. The first point in each line is the published reserves figure for that month, but subsequent points now deduct cumulative assistance.

¹¹¹⁸ Capie, *Bank of England*, Table 5.1, pp231-2. In making the transition from published to 'free' reserves, Capie deducted emergency borrowing and added the dollar portfolio which was not originally part of the published reserves

¹¹¹⁹ The 1967 crisis is truncated at end-Oct/1967, the month-end prior to devaluation. While the Nov/1967 devaluation was an interesting month, it was the capitulation stage of the crisis, it is easier to avoid devaluation effects, and the decision to devalue was arguably already inevitable by end-October

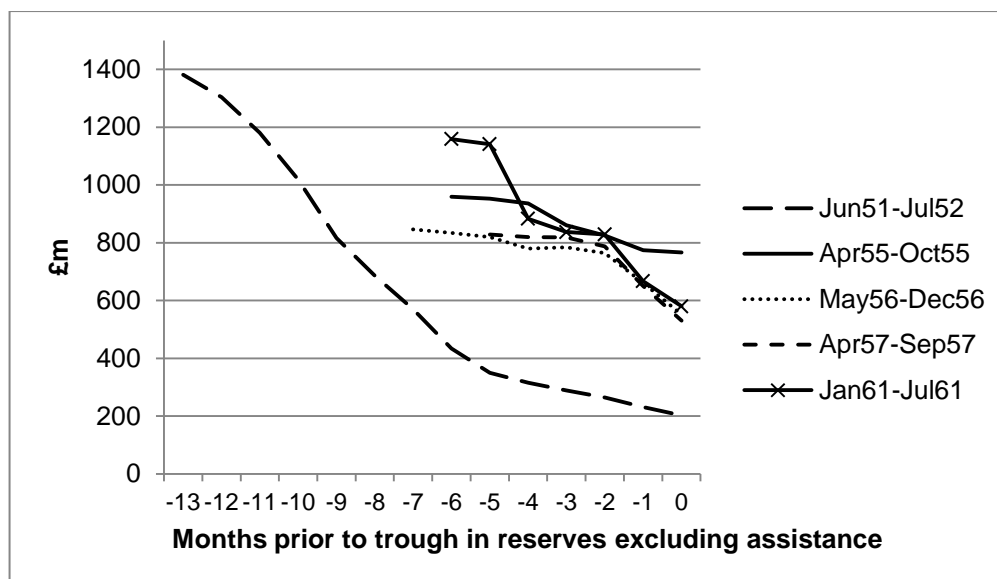


Figure 5: Adjusted UK gold and convertible currency reserves during sterling crises (being published reserves less assistance from the NSA), monthly at end-month, June 1951 – July 1961 (£m)

Source: Calculated from published reserves (BOE Statistical Abstract No.1, 1970, Table 27, pp162-3) and assistance (see Table 4)

Note: NSA = Non-sterling area

The most striking feature of Figure 5 is the scale of the 1951-2 crisis, which, but for over £400m of assistance (principally from the EPU, Defence aid and the Katz-Gaitskell agreement), came close to exhausting the UK's reserves. Indeed this and the 1956 crisis included a December month, and if the loan service on the American loans had not been treated as negative assistance in this analysis, the scale of the decline would have been more than £60m larger in each case. It is also clear that, with the exception of the 1951-2 and 1961 crises, the other crises of 1951-61 were not approaching the scale of those of 1964-7 (even allowing for inflation).

Section 5: The sterling balances and their contribution to crises

Having established assistance and the scale of the crises, we now examine the RSA's sterling balances. As noted, there has been a presumption in the literature that the sterling area's sterling balances were stable. The RSA's sterling balances looked stable from a helicopter view. However, because they were large, their absolute movements were large relative both to UK reserves and to the other contributors to sterling crises.

As an overview, Figure 6 shows the quarterly levels of RSA and NSA sterling balances over the period, from published data (here the NSA balances include assistance holdings such as the IMF's).

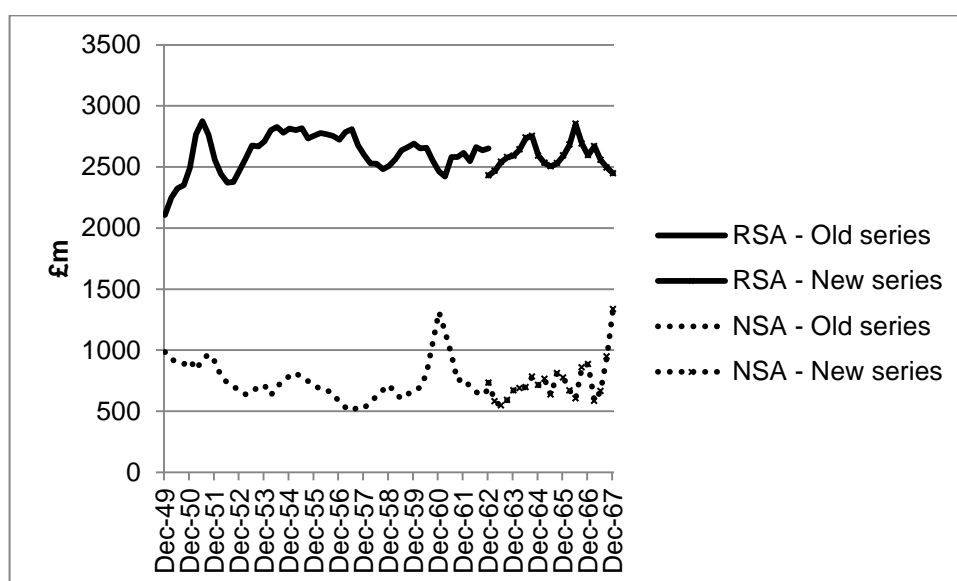


Figure 6: Sterling balances of the RSA and NSA, quarterly at end of quarter, December 1949 – December 1967 (£m)

Source: BOE:Statistical Abstract No.1, 1970, Table 21, p125 and Table 22(1), pp129-30

Note: Sterling balances = net external liabilities of the UK in sterling; RSA = Rest of the sterling area; NSA = Non-sterling area

The change in the sterling balances series in 1962 reflected a continuing attempt, through the 1950s-60s, to make the sterling balances definition correspond more closely to the idea of external short-term liquidity. The principal changes in 1962 were

to increase the number of reporting banks providing coverage, to decompose the previously reported 'net liabilities' into 'gross liabilities' and 'claims' (the latter now also including acceptances), to remove the gilt-edged holdings of institutions other than central monetary institutions (CMIs), to add the deposits of CMIs at commercial banks, and, particularly, to provide information about the types of holdings (e.g. Treasury bills, deposits, or gilts).¹¹²⁰ But there were earlier, less advertised, changes which were similarly motivated: for instance, in 1956, Dominion and Colonial sterling securities held by official bodies were removed from the RSA balances, and some UK government obligations (e.g. a negotiated debt to Portugal) removed from the NSA balances, as is revealed in the ONC reports.¹¹²¹

Given this change in 1962, it is obviously not possible to study the crises of the 1951-61 period (our core focus) from the perspective of gross liabilities versus claims, CMI versus other holdings and the types of claims/liabilities. This is only feasible for the period from 1962, and some key illustrative graphs covering 1962-7 are provided in Annex 6 (the facts are readily available in the relevant tables in the referenced Statistical Abstract). Claims were unimportant in CMI holdings, and generally the principal source of short-term movement was the gross liabilities, although claims were gradually rising during the period, and significantly so in the case of NSA non-CMI holders. The largest holdings were those of the RSA CMIs, and these fluctuated. Other RSA holdings were dominated by monetary reserves of particular countries (e.g. Ireland, Hong Kong, Kuwait, Australia and certain currency boards)¹¹²² so it is dangerous to infer broad conclusions about the movements in this group. NSA CMI holdings were strongly influenced by assistance to the UK, while other NSA holdings suggest more volatile confidence movements. The run-down of CMI holdings (and assistance uptake) was largely seen in Treasury bills, while other holders saw the

¹¹²⁰ BEQB:1963Q2, pp98-105

¹¹²¹ BOE:EID3/98-EID3/106

¹¹²² See Ireland and Australia chapters; Chapter 1, 3.3.4; and source data

principal declines in their bank deposits. However, perhaps the biggest story of the 1964-7 crises, the diversification of the RSA holders (see below), is missing from these graphs.

The apparent stability of the sterling balances in Figure 6 was misleading. For example, as we have already seen, the NSA balances consisted of a variety of different confidence and assistance holdings, and it is necessary to unravel these in order to judge the state of confidence in sterling from this source. When comparing NSA confidence balances against RSA balances, it is also the absolute movements of these balances that are of interest. Consequently, in Figures 7–9, the NSA confidence and RSA series, adjusted for ‘exiters’, are rebased to zero at the start of each of the three sub-periods (1949-58, 1958-62 and 1962-7).¹¹²³ While the trends of each series are different, in terms of absolute movements the RSA series was not less volatile than the NSA series. Indeed, for the 1950-8 period, the monthly standard deviation of the RSA series was £183m, while the standard deviation of the NSA series was £113m.¹¹²⁴

¹¹²³ The NSA confidence series in the two subsequent sub-periods (Figures 8 and 9) are calculated slightly differently than as described in the main analysis i.e. in the prior Section and in the first sub-period (Figure 7) and the results in Table 5. While there is data on assistance for each of the crisis months, it does not cover all the years in the latter sub-periods. Consequently, assistance in the calculation of Figures 8 and 9 is proxied by the holdings of regional Central Monetary Institutions (regions known to have provided assistance during the sub-period), which are recorded in the sterling balances data, as described in each Figure’s source and note. This allows the main trends to be seen. The differences are marginal. Graphs of the underlying NSA holdings for Figures 8 and 9 are provided in Annex 3

¹¹²⁴ This conclusion contrasts with that of Schenk, who argued that the NSA sterling balances were more volatile than the RSA sterling balances in this period, ‘especially in the last quarters of 1953-5’ (Schenk, *Britain*, p26). However, as earlier noted, I could not find these 1953-5 December low points in the source data (Schenk, *Britain*, Figure 2.2, p21)

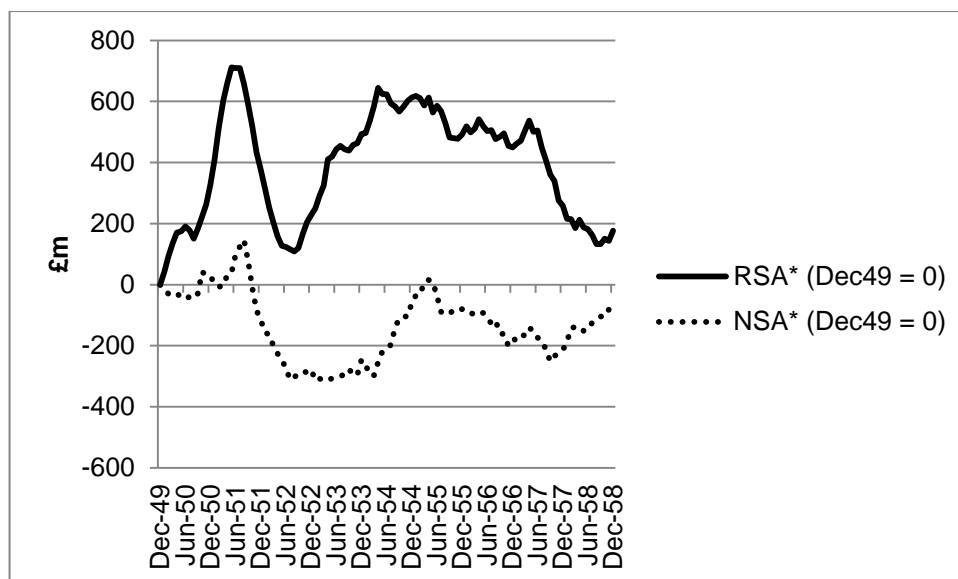


Figure 7: Adjusted sterling balances of countries associated with and outside the sterling area (the latter after deducting holdings providing assistance to the UK), monthly at end-month, December 1949 – December 1958 (£m, rebased to £0m at December 1949)

Source: As for Figure 5; RSA* includes, and NSA* excludes, Egypt, Sudan and Palestine/Israel

Note: The two series are designated RSA and NSA* in order to acknowledge the adjustments which have been made to the original RSA and NSA data. Sterling balances = net external liabilities of the UK in sterling

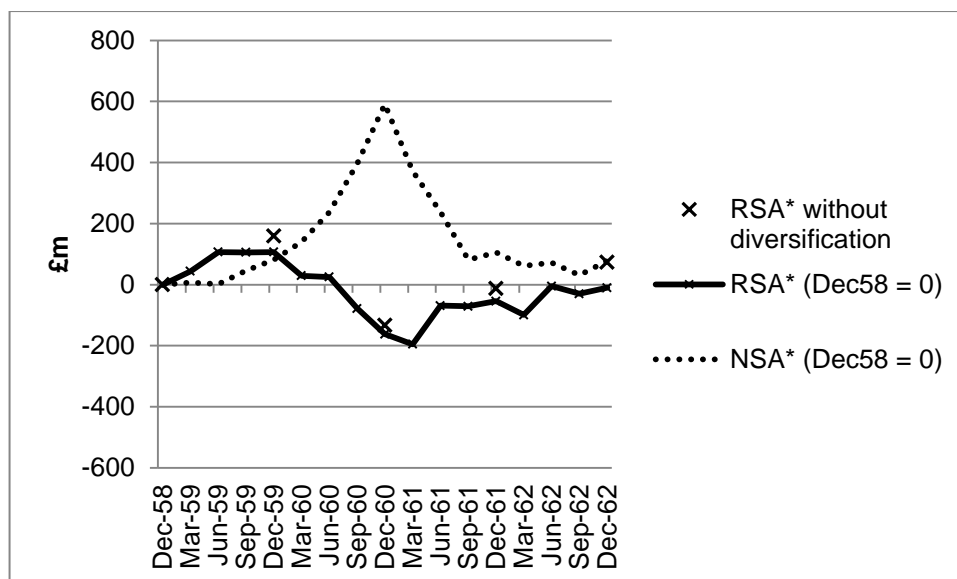


Figure 8: Adjusted sterling balances of countries associated with and outside the sterling area (the latter after excluding Western European Central Monetary Institutions), quarterly at end of quarter, December 1958 – December 1962 (£m, rebased to £0m at December 1958)

Source: The NSA* series, which excludes exiters and assistance, is calculated as follows: net external liabilities in sterling to non-sterling area countries (BOE Statistical Abstract No.1, 1970, Table 21, p125) less gross sterling liabilities to Western European Central Monetary Institutions, Egypt and Iraq (BOE:EID10/3–EID10/6). The RSA* series, which includes exiters, is similarly calculated (now using BOE Statistical Abstract No.1, 1970, Table 22(1), pp129-30), adding the same figures for Egypt and Iraq. The crosses are calculated from BOE:OV53/32, 'Sterling Area Working Party', '25.1.68', 'Statistical Appendix', 'Table I', 'Disposition of the Official Reserves of the Overseas Sterling Area (excluding South Africa and Burma)'

Note: The Figure uses gross sterling liabilities of the UK to Western European CMI, Egypt and Iraq, and net external liabilities to all NSA countries. The sterling claims are not individually specified in the COF series in the 1958-62 years. However, the Western European CMI sterling claims were minimal (typically £0-1m from 1962 (BOE:Statistical Abstract No.1, 1970, Table 22 (3), p140)). Sterling claims of the 'non-sterling Middle East' (nine countries including Egypt and Iraq) increased from £31m to £45m between end-Jan and Jul/1961 (BOE:EID10/6). In Dec/1962, at the start of the new series, Egypt's sterling claims stood at £13.6m and Iraq's at £2.5m (BOE:EID10/7). So overall the gross liabilities are not likely to have been very different from the net, and claims also tended to be more stable than liabilities and were not easily liquidated (BOE:EID1/20, 'Enquiry into the position of sterling 1964-65', Kahn, 1/6/1966, p17). The reason for treating Egypt and Iraq as exiters is as follows. Although Egypt had been out of the sterling area for more than a decade, its holdings had been blocked by the UK due to the Suez crisis, so its sterling balances were still in run-off. Iraq left the sterling area in 1959

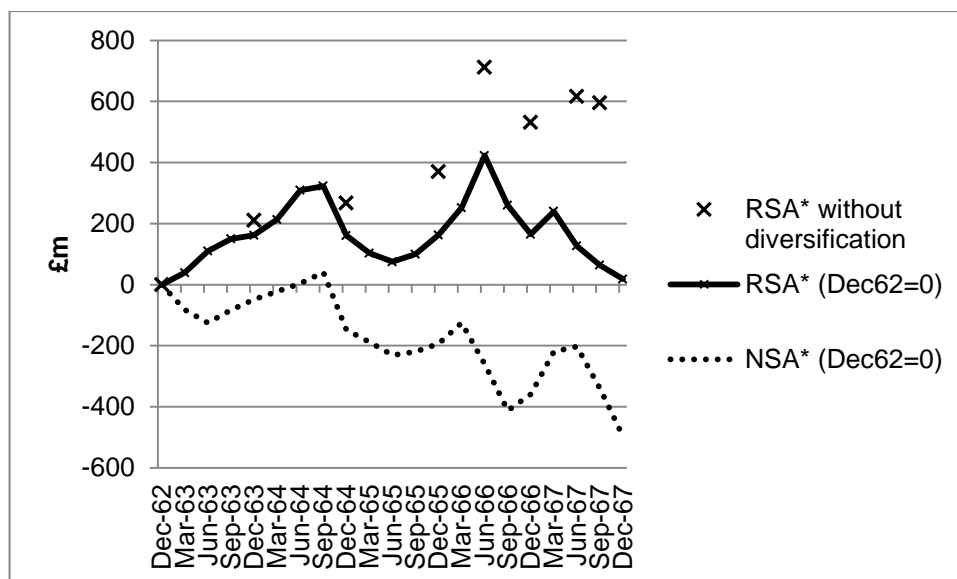


Figure 9: Adjusted sterling balances of the RSA and NSA (the latter after excluding Western European and North American Central Monetary Institutions), quarterly at end of quarter, December 1962 – December 1967 (£m, rebased to £0m at December 1962)

Source: The NSA* series, which excludes the sectors providing assistance, is calculated as follows: UK net external liabilities in sterling to non-sterling area countries, less net external liabilities in sterling to Western European Central Monetary Institutions and North American Central Monetary Institutions (BOE:Statistical Abstract No.1, 1970, Table 22(3), pp139-40). The RSA* series is taken from the same source using net external liabilities in sterling to all sterling area countries. Crosses are also calculated from BOE:OV53/32, 'Sterling Area Working Party', '25.1.68', 'Statistical Appendix', 'Table I', 'Disposition of the Official Reserves of the Overseas Sterling Area (excluding South Africa and Burma)'

Note: Burma and Southern Rhodesia exited the sterling area during this period, but reduced their holdings to a low level prior to leaving the area, so there is no need to separate these holdings out

Figures 8 and 9 also show through occasional crosses what would have happened to the RSA series holdings if the sterling area countries¹¹²⁵ had not increased their non-sterling holdings at the expense of their sterling holdings. This 'diversification' is discussed in the next Section. However, the Figures clearly show that sterling area countries were not diversifying materially away from sterling (acquiring non-sterling assets) until 1964, but they were doing so to a considerable extent in the 1964-7 crisis years (the crosses diverging from the black line in Figure 9).

What Figures 7–9 show is that the RSA sterling balances were playing a role in each of the crises of the 1951-67 years. In the 1950s crises, the RSA and NSA series experienced downswings together. In the 1961 crisis, the major cause of the crisis was

¹¹²⁵ Excluding South Africa and Burma, as explained in Section 6

the withdrawal of NSA balances (particularly non-official holdings from the USA and Western Europe) which had been attracted to the UK during 1960, largely by relative interest rates and the then weakness of the US dollar.¹¹²⁶ But the RSA balances also played a part: between December 1959 and March 1961 (the crisis month in which the Bank of England received central bank assistance at Basle), there was a downswing of more than £350m.¹¹²⁷ Finally, in the 1964-7 crises, while the net downswing of the NSA series was significant,¹¹²⁸ the RSA series was also subject to major downswings (e.g. 1964-5), and the effect of the cumulative diversification by RSA countries was as important as the trend in the NSA series.

The reader will also be interested in the extent of the statistical correlation between some of the aforementioned sterling balance variables and the UK reserves variables. Looking at the crude sterling balances data from Figure 6, and the correlation with the published reserves, quarterly from December 1949 to September 1967 (pre-devaluation), the correlation with reserves was +45% for total sterling balances (and +32% for RSA sterling balances). These are not particularly high correlations given the underlying accounting identity. However, if one considers the monthly data from the ONC reports, from December 1949 to December 1958, the correlation between total sterling balances and published reserves for this earlier period was higher at +67%. Finally, for the same monthly 1949-58 period, using the series underlying Figure 7 (adjusted sterling balances) against adjusted reserves, the correlation with adjusted reserves (net of assistance) was +80% for total adjusted sterling balances (net of NSA assistance holdings) and +55% for adjusted RSA balances (including exiters). These are stronger correlations. Correlation does not imply causation, but if one of the

¹¹²⁶ BEQB:1963Q4, p265

¹¹²⁷ The subsequent rebound in the RSA series was due largely to an IMF drawing by Australia in Apr/1961 (see Australia paper)

¹¹²⁸ The UK's net external liabilities in sterling to NSA countries, other than North American and Western European central banks, declined from over £400m in 1963, to practically nothing by end-1967 (see Annex 3, Figure A2). This rather undermines the claims of BOE officials, in the 1960s: they had emphasised sterling's 'commercial role', reflected in private traders' 'working balances', saying that by 1963 the non-official holdings of the NSA were 'not much more than is needed for normal trading and commercial activities' (BEQB:1963Q4, p275)

variables (adjusted reserves) is clearly being acted upon in a financing role, and if the other (adjusted RSA sterling balances) has autonomous fundamental drivers, there is at least the possibility of a causal connection.¹¹²⁹

Having reviewed what was happening to sterling balances across the period, we can now show the relative contribution of the sterling area's balances to decreases in adjusted reserves during crises, adopting Kahn's methodology. The results are displayed in Table 5.

Crisis period (end-months, peak to trough in adjusted reserves - see Column B)	Assistance received	Reserves movement less assistance received	RSA sterling balances (including exiters*)	NSA sterling balances (excluding assistance and exiters*)	Residual (including UK balance of payments)
	Column A	Column B	Column C	Column D	Column E
	£m	£m	£m	£m	£m
Jun51-Jul52*	410	-1178	-593	-411	-174
Apr55-Oct55	54	-192	-133	-96	+37
May56-Dec56*	210	-294	-71	-102	-121
Apr57-Sep57	130	-298	-178	-110	-10
Jan61-Jul61	296	-579	+80	-467	-192
Jul64-Jan65	657	-792	-278	-308	-206
May65-Aug65	319	-417	+58	-142	-333
Jan66-Sep66	752	-701	+62	-371	-392
Apr67-Oct67	545	-758	+154	-401	-511

Table 5: Changes in reserves and sterling balances, and assistance from the NSA, during sterling crises, monthly at end of month, 30 June 1951 – 31 October 1967 (£m)
Source: For 1951-7, as for Figure 7 and Annex 2; for 1961, as for Figure 8, except for assistance which derives from BEQB:1976Q1, pp78-81; for 1964-7, as for Figure 9, except for assistance which is as for Figure 4

*Note: Not treating the American loan debt service as negative assistance would increase the absolute (negative) magnitudes of Columns B and E by £63m in 1951-2 and by £67m in 1956. Including window-dressing in Nov/1956 would further increase these magnitudes by £43m in 1956. 'Exiters' in 1951-7 were Egypt, Sudan and Palestine/Israel. 'Exiters' in 1961 were Egypt and Iraq. In 1964-7, there were no NSA countries classed as 'exiters' for this purpose since Burma and Southern Rhodesia reduced their sterling balances while included within the RSA. (Sterling balances = Net external liabilities of the UK in sterling; RSA = Rest of the sterling area; NSA = Non-sterling area)

Table 5 is interpreted as follows. The numbers in Columns C, D and E together sum to the number in Column B, which gives the scale of each crisis. Following Kahn, movements in the NSA balances (Column D) can be assumed to be confidence

¹¹²⁹ The data behind these correlations are the sterling balances, reserves and assistance series underlying Figures 5-7

movements responding to the fundamental elements of crisis. By contrast, movements in the RSA balances (Column C) largely reflected, until deliberate RSA diversification and UK capital flight to the RSA in the 1964-7 period, the fundamental balance of payments of the RSA. The residual (Column E) incorporates a significant fundamental element (the UK balance of payments) but also confidence flows (e.g. UK capital flight, leads and lags, and, in the 1960s, activity in the eurocurrency markets) which are expected to be negative during a crisis. The comparison of interest is in the relative magnitudes in Columns C and E since they contain the fundamental elements. Interestingly, in 1951-2, 1955 and 1957, the RSA sterling balance movement was more negative than that of the residual. In the 1956 crisis, the RSA sterling balances decreased materially although speculative elements (in Columns D and E) predominated (especially after making the adjustments noted in Table 5).¹¹³⁰ The negative movement of the sterling area's sterling balances in the 1964 crisis was also significant.

This first stage of the argument has shown that the sterling area's sterling balances seemed to play a role in all the crises of the 1951-67 years. Sometimes the change was indirect (e.g. significant diversification during the 1965-7 period despite sterling balances increasing), or more in the run-up to the start of the crisis, and dominated by other capital movements overall (the 1961 crisis). But the sterling area's sterling balances are particularly notable in the crises of the 1950s. Ultimately, of course, all these crises and reversals of policy were attributable to the UK's inadequate reserves, in answer to which a stronger UK balance of payments on current and long-term capital account was certainly required.

¹¹³⁰ The scale of the 1956 crisis as represented by Column B seems smaller than Klug and Smith suggested. However, the approach is different. Klug and Smith were trying to demonstrate the speculative scale of the crisis by stripping out 'one-off' items such as the UK's sale of the Trinidad Oil Company (US\$177m), and gold sales to the UK by Australia (US\$54m) and South Africa (US\$47m) (Klug and Smith, 'Suez and sterling', p193). However, here these items do not qualify as assistance from the NSA, and so their effect is implicit in Columns E and C respectively

Section 6: Co-operation and flows within the sterling area during crises

The previous Section highlighted the changes in the RSA's sterling balances during sterling crises. This Section examines the geographic and other sources of the declines in these sterling balances during the 1951-61 crises. It reviews the types of flows (fundamental, confidence and assistance) within the sterling area. It considers the nature of co-operation exhibited within the sterling area.

Declines in sterling balances during the crisis periods tended to be concentrated in a few large holders, albeit in the 1957 crisis almost all the geographic regions of the sterling area were experiencing declines in sterling balances. Table 6 sets out the five countries or regions showing the largest declines in sterling balances during each of the 1951-61 crises.

£m	Jun51-Jul52	Apr55-Oct55	May56-Dec56	Apr57-Sep57	Jan61-Jul61*
1.	Australia -399	Australia -87	India -132	India -104	India -39
2.	India -133	Egypt -30	N Zealand -25	Iraq -20	Ghana -18
3.	Egypt -92	Ireland -17	W Africa -24	Egypt -15	Nigeria -18
4.	Pakistan -74	N Zealand -17	Egypt -17	N Zealand -15	Pakistan -17
5.	N Zealand -48	BW Indies -13	Pakistan -14	Pakistan -15	Iraq -16
Top 5	-746	-164	-212	-169	-108
All	-593	-133	-71	-178	+62

Table 6: Changes in sterling balances of RSA/ex-RSA countries during sterling crises, showing five largest declines, end-month to end-month, June 1951 – July 1961 (£m)

Source: Calculated from BOE:EID 3/98–EID3/106; EID10/5

*Note: Gross external liabilities for the 1961 crisis (the net figures are not available). Otherwise, sterling balances = net external liabilities of the UK in sterling.

BW Indies = British West Indies (principally The Bahamas, Barbados, Bermuda, British Guiana, Jamaica, Trinidad and Tobago), N Zealand = New Zealand, W Africa = West Africa (includes The Gambia, Ghana, Nigeria, Sierra Leone). RSA = Rest of the sterling area

Table 6 suggests that there was sufficient liquidity in the holdings of some countries to cause problems for sterling. Was it possible that the declines in RSA sterling balances were confidence movements in response to the crisis, rather than being caused by the fundamental balance of payments of the countries concerned – as the UK government claimed (see Table 3)? In other words, did the cause of this possible contribution to crisis lie elsewhere? The answer is no. It is straightforward to identify large confidence

movements within the sterling area. This is because the sterling area countries were supposed to be pooling their reserves with the Bank of England and using sterling as their reserve currency. To deliberately accumulate non-sterling reserves was a breach of the pooling rule. Confidence movements are reflected in increasing non-sterling reserves.

Sterling area countries' accumulation of non-sterling reserves was closely monitored at the time by the Bank of England, and these 'gold and dollar pots' were a theme of diplomatic discussion which has been carefully recorded.¹¹³¹ In 1966-8, in response to the crisis, the Bank looked back at the historical build-up of non-sterling reserves in the sterling area from 1955. This is shown in Figure 10. Figure 10 covers all then sterling area countries except South Africa (outside the pooling arrangements) and Burma, which in 1966 left the sterling area, having undertaken a rapid diversification since 1964. In the 1950s and early 1960s, the rate of increase of non-sterling reserves in the sterling area was around £1m per month, an insignificant sum in the context of these crises. This lack of deliberate diversification was also true of the first half of the 1950s, as confirmed in a table from Schenk's 1994 book.¹¹³²

¹¹³¹ Particularly in TNA:T267/29, 'Sterling balances'

¹¹³² Schenk, *Britain*, Table 2.5, p30

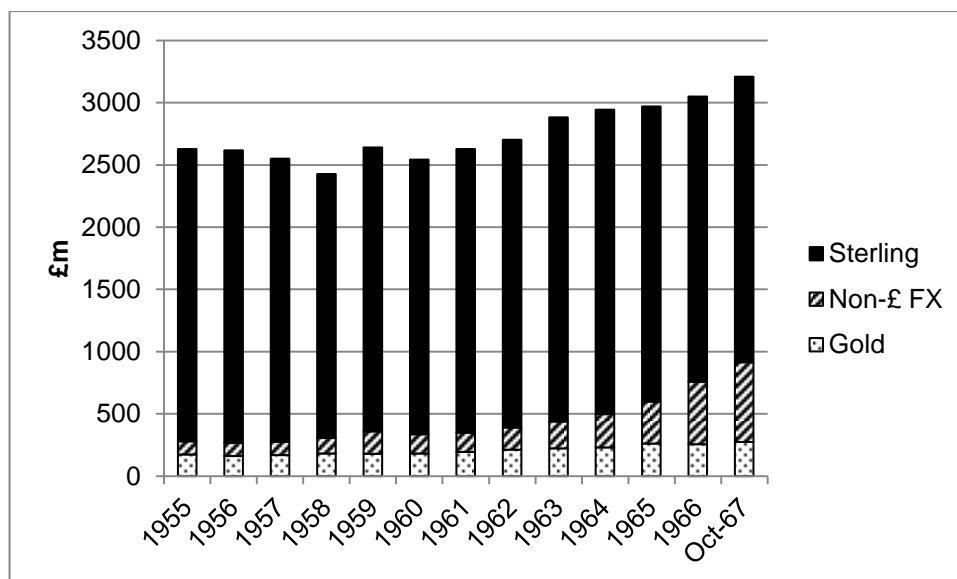


Figure 10: Official international reserves of RSA countries (excluding South Africa and Burma), divided into sterling, gold and other holdings, annually at 31 December, 1956 – 1966 and at 31 October 1967 (£m)

Source: Data extracted from BOE:OV53/32, 'Sterling Area Working Party', '25.1.68', 'Statistical Appendix', 'Table I', 'Disposition of the Official Reserves of the Overseas Sterling Area (excluding South Africa and Burma)'

Note: RSA = Rest of the sterling area

There were, in addition, those countries which exited the sterling area, such as Egypt and Iraq. But their holdings were reduced gradually over time. As Figure 3 showed, the trend in their balances was different from the more volatile confidence movements experienced by NSA holders excluding assistance.

Was it possible that the RSA's sterling balances declined in crises not because of deliberate diversification (reflected in non-sterling reserves) but through other confidence movements of sterling from the RSA to the NSA? Again the answer is almost certainly no. Taking the case of Australia in 1951-2 or 1955, for instance, Australian exchange controls were strict and prevented such capital outflows, and in any event these were known balance-of-payments crises for Australia.¹¹³³

¹¹³³ See Australia paper. In addition, as already noted, in its analysis of the 1957 crisis, the BOE found no confidence movements in the RSA sterling balances (BOE:EID16/8, '...1957, 1961 and 1964/65 Crises', 'Table III...Confidence Movements', 12/1/1966)

Did some of the sterling area countries provide assistance to the UK during these sterling crises? This has been a claim in the literature.¹¹³⁴ However, there is limited evidence of such assistance. The countries which are most frequently named as providing assistance, through gold or dollar sales to the UK, were Australia and South Africa. Their sterling holdings during the crises are given in Table 7:

£m		Australia	South Africa
Jun51-Jul52 crisis	Jun 1951	626	73
	Jul 1952	227	55
	Change	-399	-18
Apr55-Oct55 crisis	Apr 1955	290	30
	Oct 1955	203	15
	Change	-87	-15
May56-Dec56 crisis	May 1956	182	12
	Dec 1956	259	24
	Change	+77	+12
Apr57-Sep57 crisis	Apr 1957	354	6
	Sep 1957	375	-5
	Change	+21	-11
Jan61-Jul61 crisis*	Jan 1961	233	13
	Jul 1961	381	14
	Change	+148	+1

Table 7: Changes in sterling balances of Australia and South Africa during sterling crises, end-month to end-month, June 1951 – July 1961 (£m)

Source: Calculated from BOE:EID3/98–EID3/106; EID10/5

*Note: Gross external liabilities for the 1961 crisis (the net figures are not available). Otherwise, sterling balances = net external liabilities of the UK in sterling

Through a series of formal and informal agreements with the UK, South Africa sold most of its gold production in London for sterling.¹¹³⁵ This benefited the City of London as a financial centre and the Bank of England as a gold market participant, but South Africa's net support for the sterling area was measured by its net holdings of sterling, which were small and generally declining. As Table 7 shows, the only crisis in which South Africa's sterling holdings increased materially was the 1956 crisis, and even then the increase was a mere £12m. It has been claimed that South Africa's use of the Bank of England as its gold selling agent in London gave the latter a degree of control

¹¹³⁴ For Australia, Robertson, 'The decline?', p113; for South Africa, Berridge, *Economic power*, pp38-44

¹¹³⁵ Berridge, *Economic power*, pp38-44

in protecting sterling from storms.¹¹³⁶ But if that were important, South Africa's net sterling holdings would have increased particularly in the month of November 1956, which was the epicentre of the Suez crisis. In fact, South Africa's net sterling holdings increased only slightly in that month, from £21m to £24m.¹¹³⁷ Thus South Africa's role as a provider of more than superficial assistance can be largely discounted.

Likewise, Australia's policy focus was understandably on the level of its own reserves given the volatility of its balance of payments. It occasionally sold gold or dollars for sterling, but always because it was running short of sterling and needed to stock up on sterling as a transactional reserve.¹¹³⁸ The sale of £20m of gold to the UK during the Suez crisis in September 1956 has been cited as an example of Australian assistance.¹¹³⁹ However, the sale was motivated by an Australian need for sterling which had been anticipated by its officials long before the Suez crisis erupted.¹¹⁴⁰

Given that the 1951-2 crisis as here defined lasted for just one month more than a full Australian financial year (end-June to end-June), and given Australia's share of the RSA sterling balances decline set out in Table 6 (£399m out of £593m), one can explore this crisis in more detail using Australian data for the 1951-2 year. Australia was at the centre of the wool price boom and bust associated with the Korean War. The purpose is to get behind the figures to see how the UK reserves might have been affected by changes within Australia. From the ONC reports, the June-June decline in Australia's sterling balances in 1951-2 was £391m (£626m less £235m). From Australian records, the decline in official reserves in sterling ('Other foreign exchange')

¹¹³⁶ Berridge, *Economic power*, pp62-4

¹¹³⁷ BOE:EID3/104. Referring to Nov/1956, Klug and Smith wrote that 'significant losses would have occurred... had not \$42.7 million been made available by the South African Reserve Bank' (Klug and Smith, 'Suez and sterling', p192). But the BOE source highlighted that this was the gross value of South African gold sales, both to the UK and the market. Moreover South Africa also separately contributed dollar losses of \$20.3m (BOE:EID3/114, 'Gold and dollar reserves', 'E.E.A...November 1956', 3/12/1956)

¹¹³⁸ See Australia paper

¹¹³⁹ Boughton, 'Northwest of Suez', p437; Klug and Smith, 'Suez and sterling', p193; Kunz, *The economic diplomacy*, pp100-1, 146; Kirshner, *Currency and coercion*, pp67, 109

¹¹⁴⁰ See Australia paper

over this period was £369m (£600m less £231m).¹¹⁴¹ Australia's current account deficit in 1951-2 was £435m, from a surplus of £100m in 1950-1. This was mitigated by a capital account surplus of £95m. Within the current account, the trade deficit was £283m, from a surplus of £203m in 1950-1, and the invisibles deficit was £152m.¹¹⁴²

It is interesting to examine where this nearly £500m deterioration in the trade deficit occurred. For an indication, see Table 8 (albeit using trade figures on a recorded rather than balance-of-payments basis), which shows that, between 1950-1 and 1951-2, the balance with the UK deteriorated by £177m (the deficit increased from £29m to £206m) while the balance with 'core NSA' countries (USA, Japan, France, Germany, Italy and the Benelux countries) worsened by £234m (the surplus falling to zero in 1951-2).

Australia's trade with (£m):	UK	Core NSA*	South & SE Asia*	Other
1950-1 Exports	256	349	51	130
1950-1 Imports	286	115	92	102
1950-1 Difference	-29	234	-41	27
1951-2 Exports	166	222	48	103
1951-2 Imports	372	222	99	149
1951-2 Difference	-206	0	-51	-46
1952-3 Exports	288	260	59	90
1952-3 Imports	172	103	54	83
1952-3 Difference	116	157	5	7

Table 8: Australia's trade with selected country groups, annual, year ended 30 June 1951 - 1953 (£m)

Source: Calculated from Norton and Kennedy, *Australian economic statistics*, pp4, 6, 7, 9

*Note: 'Core NSA' = USA, Japan, France, Germany, Italy, and Benelux countries; 'South & SE Asia' = Bangladesh, Brunei, Burma, Hong Kong, India, Malaysia, Maldives, Pakistan, Singapore, Sri Lanka (RSA countries) and Indonesia, Kampuchea, Laos, Macao, Philippines, Taiwan, Thailand, Vietnam (NSA countries)

On the other hand, since a large part of South & South-East Asia consisted of sterling area countries, and there was a significant UK element also to the invisibles deficit,

¹¹⁴¹ Calculated from Norton and Kennedy, *Australian economic statistics*, p26

¹¹⁴² Calculated from Norton and Kennedy, *Australian economic statistics*, pp2, 23

Table 8 also shows that much of the absolute Australian deficit in 1951-2 was with the sterling area (e.g. the deficit of £206m with the UK), and, dependent on other trends in the RSA, the resulting pressures on the UK reserves would therefore presumably have been through the indirect channel (arrow c in Figure 2). This is also suggested by Scott's UK balance-of-payments table for 1951-2 which showed an overall deficit requiring financing of £1,150m: the RSA's deficit with the NSA was only £149m; that deficit plus the RSA's current deficit with the UK amounted to £637m; and the change in the RSA's sterling balances was £519m (Scott's RSA numbers did not include the 'exiters').¹¹⁴³

However, to dismiss the decline in Australia's sterling balances because its absolute deficit was largely with the UK seems questionable given that much of the deterioration was in trade with the NSA. This illustrates that the flows within the sterling area's balance of payments were part of a balanced mechanism. In 1965, the Bank's chief cashier, Fforde, alluded to this problem, suggesting that it was not the absolute balance with the NSA that mattered for the UK's reserves:

'Strictly speaking, the pressure on U.K. reserves arising from a cyclical deterioration in the O.S.A.'s [Overseas Sterling Area] balance of payments consists of the difference between the prevailing O.S.A. balance with the N.S.A. and the balance that "would otherwise be the case". What would "otherwise be the case" is a judgement, not a precise statistical quantity'.¹¹⁴⁴

Table 8 also shows that the boom in Australia's export income of 1950-1 translated into increased imports in 1951-2 (an example of macroeconomic knock-on effects that

¹¹⁴³ Scott, 'The balance of payments', p214

¹¹⁴⁴ BOE:OV44/151, Draft, 'The problem...', 29/10/1965, p10

was well-recognised at the time).¹¹⁴⁵ Those analysts who wrote about the 1951-2 crisis in the 1950s were clear that the sterling area's problem was excessive imports in the RSA as well as the UK.¹¹⁴⁶ Thus Katz called the 1951-2 crisis the 'lagged response to an export boom'¹¹⁴⁷ and noted that the UK's reaction to crises was to cut back on imports and run down inventories, which had to be restocked with more imports when the crisis had passed:

'The recurring import deficits of the outer sterling countries, combined with Britain's policy of periodically depleting import inventories, were the two factors mainly responsible for sterling's recurring postwar difficulties'.¹¹⁴⁸

This was recognised, however, as a boom-bust cycle, and by the mid-1950s, with the abandonment of cheap money and some controls in the UK, reduced liquidity in the RSA's reserves and a terms-of-trade improvement for the UK from cheaper wheat, commentators were hopeful that the sterling area had achieved a better overall balance with the NSA.¹¹⁴⁹

In this context, the scale of the decline in the RSA's sterling balances during the 1955-7 crises seems significant. In 1957, India was the biggest source of that decline (see Table 6). Bhagat found that India's deficit with the (ex-UK) OEEC group of countries (continental Europe) was as large as £185m in 1957, albeit partially mitigated by a surplus with the dollar area.¹¹⁵⁰

This Section has shown that the movements in sterling balances during the 1951-61 crises reflected neither confidence nor assistance but the fundamental balance of

¹¹⁴⁵ See Copland, *Inflation and expansion*, pp50-1: 'the price of wool... Unquestionably it is the biggest inflationary force in Australia, and it will spread and spread'

¹¹⁴⁶ See Paish, 'The sterling area crisis'; Stevens, 'Some notes'

¹¹⁴⁷ Katz, 'Sterling's recurring', p221

¹¹⁴⁸ Katz, 'Sterling's recurring', p222

¹¹⁴⁹ Katz, 'Sterling's recurring'; Stevens, 'Some notes'

¹¹⁵⁰ Bhagat, 'Working', pp213-5

payments of the RSA. To what extent did the sterling area co-operate to manage its collective balance of payments? Although, during 1947-52, the UK tried to propose dollar area and/or NSA balance-of-payments 'rations' to sterling area countries in a series of emergency Commonwealth financial conferences, these attempts did not receive a warm reception. Agreement was at best watered down (1949), or left unsettled (1952) and sometimes even refused (1950).¹¹⁵¹ Given widespread excess liquidity in the RSA, Katz argued that the UK's attempts to forge a 'continuous common policy' of import restraint in emergency Commonwealth summits proved, unsurprisingly, clumsy and unsuccessful.¹¹⁵² After the Commonwealth Economic Conference of December 1952 and the decision to pursue sterling convertibility as a priority, sterling area balance-of-payments co-operation effectively ended: 'the policies of individual countries became related to their own reserves position and not to that of the Central Reserves'.¹¹⁵³

Thus there was really no formal co-operation taking place in the sterling area after 1952 (arguably 1949), in the sense of ad hoc action. There was, however, shallow co-operation, information-sharing, through bilateral central bank and Treasury contacts, and the ritual of approximately annual meetings of Commonwealth Finance Ministers usually held around the time of the annual IMF meeting in September. A Whitehall committee (initially two committees), attended by UK departmental officials, the Bank of England and London representatives of the Commonwealth, also met through the 1950s and 1960s, to no great effect. The number of such committee meetings is shown in Figure 11. They steadily reduced in frequency and content save for a flurry of

¹¹⁵¹ For Australian responses to these proposals, see, for 1949, RBA:B.1.1.1.C.5.2, F.11 and F.12, Dedman to Chifley, 18/7/1949; Chifley to Courtice, 15/8/1949; for 1950, Lee, *Search for security*, p145; RBA:B.1.1.1.C.5.2, Menzies to McEwen, 22/9/1950; RBA:B.1.1.1.C.5.2, 'Dollar import policy', Spender to Menzies, 26/9/1950; for 1952, RBA:B.1.1.1.C.4.4, Text of agreed conference communique, Fadden to Menzies, 21/1/1952; Menzies to Fadden, 21/1/1952

¹¹⁵² Katz, 'Sterling's recurring', p222

¹¹⁵³ TNA:T267/29, 'Sterling balances'. A 1958 Australian review of the sterling area's 1952 convertibility plan said that it 'imposed no obligations on Australia other than to continue its existing policies' (NAA:A1838,708/13/4PART2,330620, 'An Australian view of "The Collective Approach"', May/1958). There was thus no fiscal or monetary macroeconomic co-operation. Even interest rates diverged, despite the peg, because there were capital controls in the RSA and money markets were not well-developed in the RSA

concern associated with the UK's EEC application in 1961-2. While 15-20 meetings per year in the second half of the 1950s might still seem a large number, these meetings were attended by embassy (High Commission) officials who were already resident in London, and the real test of their relevance was their informational content, which was limited and avoided policy questions. There was a stark difference between the content of discussion in the late 1940s and that in the mid-1950s.

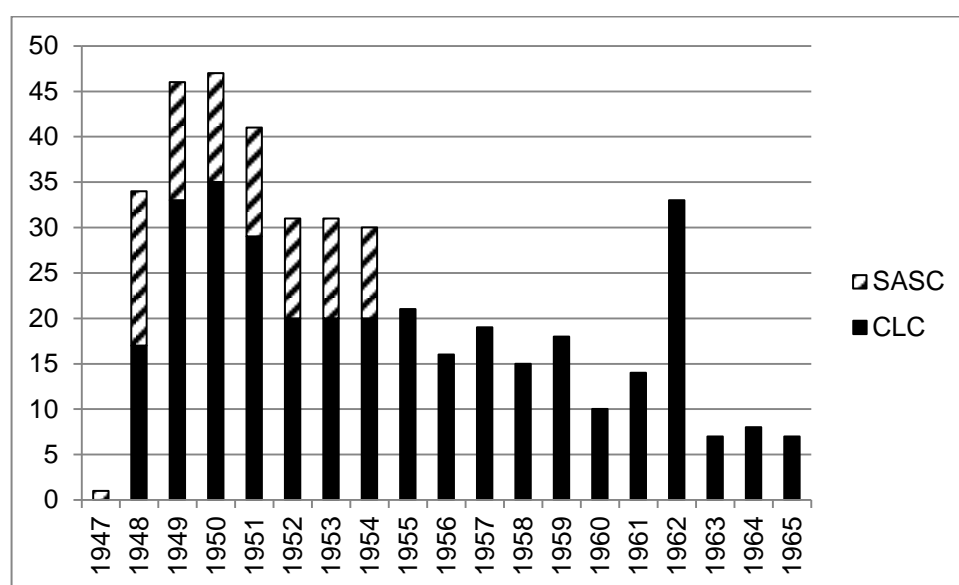


Figure 11: Number of meetings in each calendar year, Sterling Area Statistical Committee (SASC) and Commonwealth Liaison Committee (CLC), 1947 – 1965 (Number)

Source: TNA:T236/3592; T236/3593; T236/3594; CAB133/18; CAB133/19; CAB133/21; CO852/1340/3; DO35/6928; DO35/6931; DO35/6933; DO35/5618; DO35/5620; DO35/5621; DO215/151

Above all, there was deep, informal co-operation through the pooling of reserves and the design of national exchange control regimes. This continued for a long time.

Despite diversification in 1964-7, sterling area countries generally followed the pooling rule throughout the 1960s as well as the 1950s. This can be shown, at country level, by comparing the monthly sterling balances in the COF reports with the aggregate official reserves from the IMF database.¹¹⁵⁴ Sterling balances and aggregate reserves tracked each other closely. Annex 4 contrasts the reserve management behaviour of RSA countries such as India and Australia, with the behaviour of NSA countries such

¹¹⁵⁴ The sterling balances data included non-official holdings, but the monthly correlation pattern is still evident (see Annex 4)

as Canada and Thailand, where sterling balances were uncorrelated with aggregate reserves. There were also a few hybrid cases on both sides. Within the RSA, South Africa allowed its sterling holdings partially to track its reserves at least until it left the Commonwealth in 1961. Within the NSA, the sterling balances of Denmark and Argentina, close trading partners of the UK, also, for a time, partially increased and declined with aggregate reserves.¹¹⁵⁵

There can be little doubt that reserve pooling limited confidence movements against sterling within the sterling area. Deliberate diversification was likely to be observed by the UK, and the privileges of membership of the sterling area, such as access to capital, were potentially at stake. Reserve pooling thus helped to stabilise sterling to a degree. However, the important point is that reserve pooling did not address the core weakness of the sterling area, namely its overall (UK and RSA) balance of payments with the NSA.

In summary, sterling's vulnerability in 1949-67 was attributable to the balance of payments of the sterling area (UK and RSA) as a whole. Because this balance of payments was inadequate, the UK's reserves, which were always the first line of defence for the sterling area given the RSA's transactional use of sterling, did not increase in size even as the sterling area's imports grew. As Figure 12 shows, the ratio of UK reserves to sterling area imports from the NSA therefore became increasingly stretched over time, so it is not surprising that the sterling area system's demise was marked by crisis and devaluation. As a co-operative system, the sterling area was not set up to solve this balance-of-payments problem, and the UK's own attempts to improve its balance of payments to match sterling's international role were unsuccessful.

¹¹⁵⁵ See Annex 4 and its sources

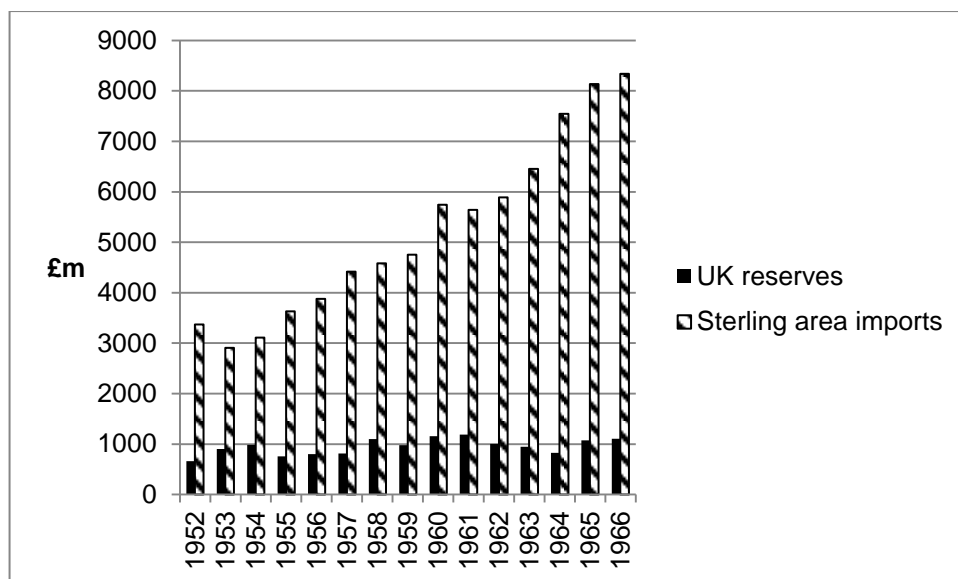


Figure 12: UK published gold and convertible currency reserves at 31 December, and sterling area merchandise imports from the NSA, annually, 1952 – 1966 (£m)

Source: BOE:Statistical Abstract No.1, 1970, Table 27 'Official reserves', pp162-3; RBA:GDB-71-1, 'The Sterling Area balance of payments', International Committee, 2/5/1967, 'Table IV, Sterling Area trade'

Note: NSA = Non-sterling area

Section 6: Conclusion

This paper examines the sterling crises of the 1950s and 1960s in order to investigate the sterling area's role in these crises and the nature of sterling area co-operation. I argue from new archival evidence that the sterling area, through negative movements in the sterling balances, and diversification in 1964-7, seemed to play a role in all these crises. In particular, the RSA's sterling balances saw significant declines in the crises of 1951-2, 1955 and 1957, declines which were large relative to other explanatory factors within the balance-of-payments accounting identity.

For contemporaries, this was not a new idea. Writing in the 1960s, Scott made a similar connection using annual (rather than, as here, monthly) data.¹¹⁵⁶ While some commentators denied that the RSA's sterling balances were volatile or declined during sterling crises, the UK government actually commented on the declines (see Table 3), but attributed them mainly to a confidence movement, reacting to UK vulnerabilities. Against this background, the contribution of the paper has been twofold. Firstly, by quantifying the scale and timing of the crises in terms of reserves less assistance (a continuous peak-to-trough decline over a number of months), it has been possible to compare the movement in the RSA's and NSA's sterling balances with 'everything else': the declines seen in the 1950s crises were relatively large compared with 'everything else'. Secondly, by showing that the RSA countries were not diversifying much into gold and dollars before 1964, it reveals, contrary to the government's claim, that these were not confidence movements, but fundamental in nature, driven by the RSA's balance of payments – indeed that of a few large countries, such as Australia, India and a handful of others.

¹¹⁵⁶ Scott, 'The balance of payments', p214

The RSA countries were naturally looking after their own interests and development needs.¹¹⁵⁷ Co-operation within the sterling area, apart from information-sharing, was largely restricted to (informal) reserve pooling and, to some extent, exchange control. There was little evidence of other assistance to the UK. Reserve pooling limited diversification, and therefore had some stabilising benefits, but it did not address the sterling area's fundamental vulnerability, namely its overall balance of payments with the rest of the world. Over time, the increasing stretch between UK reserves and sterling area imports made crisis inevitable. There are grounds for scepticism, therefore, in the merits of the sterling area as a co-operative system.

While the paper has discussed the routes through which a decline in sterling balances might have affected the UK's reserves, it is not conclusive. This is because it is a simulation of Kahn's methodology, with associated limitations. Focusing only on crisis periods is incomplete analysis, and the critics and defenders of the sterling area system had different mental models about the sterling area's balance of payments. The same arguments and mental models can be found in the subsequent historiography (which has generally been more favourable to the defender view) so the issue remains unresolved. The contemporary defenders denied that a net sterling flow from the RSA to the UK would have an effect on reserves, essentially because the effect was not 'direct'. Kahn's methodology implied that all such flow would have a macroeconomic effect on reserves. There is some support in the contemporary literature for Kahn's methodology. Scott compared the two approaches: he argued that, as international settlements changed, the decline in the RSA's sterling balances became a more relevant measure of the RSA's contribution to crises than the RSA balance with the NSA.¹¹⁵⁸

¹¹⁵⁷ As Schenk observed in *Britain*, p135

¹¹⁵⁸ Scott, 'The balance of payments', pp 211-2

What does sterling's history tell us more generally about co-operation and currency crises? Firstly, for an international co-operative regime to be judged successful, it should address imbalances, whether they be external (as in the case of the sterling area) or internal (as in the case of the Eurozone today). Secondly, the sterling area experience does not fully fit Kaminsky's classes of currency crisis – financial excesses, self-fulfilling, sudden stop, current account, sovereign debt, fiscal deficit. Issuers of international reserve currencies may be a special case.

The paper has also shown the scale of assistance during the crises of 1951-61, and deconstructed the sterling balances of the NSA to reveal that the core holdings of the NSA, after stripping out assistance, and exiters from the sterling area, were much smaller than the headline figures suggested. These net holdings were volatile and by the end of 1967 had effectively disappeared. This suggests that common talk in the 1960s of reducing sterling's 'reserve' role while retaining its 'commercial' role¹¹⁵⁹ did not make practical sense. There was little to sterling's international role which did not rely on its reserve currency use by members of the sterling area, in conjunction with exchange controls.¹¹⁶⁰

Even if one accepts a link between the RSA's sterling balances and sterling crises, these findings do not exonerate the UK from the weaknesses of its own balance of payments, which were particularly evident in the crises of the 1960s.¹¹⁶¹ Nor do they imply that co-operation in the sterling area could have been any deeper or stronger than it was. Nor is it obvious what palatable alternatives to the sterling area were available to the policymakers of the 1950s. Nor does the evidence of RSA contribution to crisis settle the direction of causation (if any) between sterling crises and UK

¹¹⁵⁹ Schenk, *The decline*, pp208, 254-5

¹¹⁶⁰ Similarly, the drive to convertibility in the 1950s is more easily construed as a move demanded by the sterling area, and required to preserve it, than a signal that UK policymakers had lost interest in the sterling area system. For a clear statement on this, see Fforde, *Bank of England*, p475

¹¹⁶¹ Weaknesses in the sense of 'overstretched', rather than a more 'declinist' meaning. See Tomlinson, 'Balanced accounts'

productivity. Still, the striking observation over this period is the Bank of England's defence and denial of the link: despite close attention paid to the sterling balances internally, crises were attributed to domestic weaknesses or speculative factors outside the sterling area. Since the Bank controlled the data, this may have had the effect of limiting broader policy discussion about the sterling area system, since outsiders could only guess what was happening at a granular level. This paper has highlighted the different assumptions made by the protagonists in the contemporary debate, and brought the evidence about the volatility of the sterling balances into the light.

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BOE	Bank of England Archive, London
TNA	The National Archives of the UK, London
NAA	National Archives of Australia, Canberra
RBA	Reserve Bank of Australia Archives, Sydney

BEQB	Bank of England Quarterly Bulletin
BOE	Statistical Abstract No.1, 1970*

*available through the Bank of England's website, at
<http://www.bankofengland.co.uk/archive/Documents/historicpubs/statisticalabst/statabs1.pdf> (downloaded 13:41, 9/2/2017)

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Review of balance-of-payments categories, focusing on monetary movements

Balance-of-payments category (categories sum to zero)	Commentary (influence of fundamentals, confidence and assistance)
<i>Balance of current and long-term capital transactions</i>	Mainly fundamental. Some confidence flows (UK capital flight) and assistance elements. Not published on a monthly basis
<i>Balancing item</i>	Unknown; thought to be affected by confidence
<i>Balance of monetary movements:</i>	
a Miscellaneous capital	Various
b Change in liabilities and claims in non-sterling currencies	Small in the 1950s, larger in the 1960s due to the growth in the eurodollar market (sensitive to relative interest rates and confidence)
c Change in liabilities and claims in overseas sterling area currencies	Small, especially in the 1950s
d Change in liabilities and claims in sterling	Monthly data either published or available in Bank of England files. Divided between RSA and NSA. RSA mainly fundamental (some confidence in 1964-7). NSA confidence (but also assistance)
e Change in official holdings of non-convertible currencies	Very small
f Change in the account with the IMF	Assistance
g Transfer from HM Government's dollar portfolio to the reserves	Assistance. The transfer was only relevant to the 1966-7 period
h Change in the gold and convertible currency reserves	Monthly data published. The main barometer of crisis, caused by the other moving parts. Deduct all assistance in order to show the true scale of the crisis

Table A1: The UK balance-of-payments accounting identity

Source: For column 1, BEQB:1968Q1, pp34-40; for column 2, idem and author's assessment

The balance of payments consists of current transactions (e.g. trade in goods and services), long-term capital transactions (e.g. long-term international loans), monetary movements (i.e. other capital items) and a balancing item which enables all the elements to sum to zero. In the table above, changes in the sterling balances are found in (d) and published reserves in (h). The table provides commentary on the role of fundamentals, confidence and assistance in each of these categories. For further information, see the BEQB source.

Assistance to the UK from the non-sterling area not matched by sterling balances, 1950-8

Dollar area assistance (+) or payment (-)	Period	Amount received (£m)	Comment
Canadian loan drawings	Jan 50 – Jun 50	+16	Last drawings under the 1946 Canadian loan
European Recovery Program (ERP)	Jan 50 – Oct 51	+314	Marshall Plan aid
UK's initial debit balance in EPU	Jul 50 – Oct 50	-54	The UK initial debit balance was like a 'handicap' in EPU for countries anticipating a surplus, in return for access to conditional aid from the USA. The debit balance had to be used up against surpluses before gold or credit could be accumulated. It thus represented hard currency foregone when those surpluses were earned
Katz – Gaitskell Agreement	Dec 51 – Nov 52	+33	This was a UK-USA agreement designed to compensate the UK for gold foregone due to pre-quota settlements of its existing resources (initial sterling balances) in EPU
Defence aid (grant and loan)	Oct 51 – Jun 58	+385	Mainly in the form of grant
American and Canadian loans – service	Dec 51 – Dec 58	-533	Interest and principal repayments, around £60-70m each year, on these 1946 loans were due to be made every December, commencing 1951
US loan service deferral	Dec 56, Dec 57	+106	Following the 1956 and 1957 crises, the USA granted 'bisques' to the UK, allowing loan service to be rolled up as capital and thus deferred
USA Export-Import Bank loan	Oct 57	+89	This was negotiated after the 1956 crisis and drawn following the 1957 crisis
Total		+268	
Window-dressing	Nov 56	+43	As reported by Klug and Smith, here treated as supplementary assistance. See text

Table A2: Selected categories of non-sterling grants and loans from the NSA, 1950 – 1958, amounts received by (+) or paid by (-) the UK (£m)

Source: Extracted from BOE:EID3/98–EID3/106 for all categories except the following: UK initial debit balance in EPU (TNA:T232/394); Katz-Gaitskell Agreement (TNA:T232/397–T 232/403); window-dressing (Klug and Smith, 'Suez and sterling', p189)

Note: NSA = Non-sterling area

There were certain categories of assistance from the NSA to the UK not matched by sterling balances. Firstly there were the large long-term American loans made to the UK by the USA and Canada in 1946. The USA loan had been drawn already but the Canadian loan was still being drawn in 1950. Logically, if one treats the drawing of these loans as positive assistance, which seems appropriate given their motivation and terms, then the correct approach is to treat the debt service on the loans, which began

in 1951, as negative assistance. The American loans had been made available as a gesture of post-war support to the UK. However, a significant proportion of the USA loan had effectively been used by the RSA as much as the UK during the 1947 crisis.¹¹⁶² Moreover, the debt service, an annual amount of over £60m equivalent paid in December, was a given quantity unaffected by the UK's international trade performance, which would drain the hard currency reserves of the sterling area, and was therefore a known problem facing the sterling area as a co-operative system. So the debt service has been treated as negative assistance¹¹⁶³ (as an alternative, its effect is also separately stripped out in the analysis). In addition, following the 1956 and 1957 crises, the USA offered a 'bisque' to the UK, allowing the December debt service in those years to be rolled up as further principal on the loan.¹¹⁶⁴

There were also grants and loans made available to the UK by the USA through the European Recovery Program (ERP, the Marshall Plan) and subsequently Mutual Defence Aid. Then there were non-sterling elements to the EPU arrangements. The UK had an initial 'debit balance' in EPU, as the sterling area was expected to be in surplus with the EPU, and this debit balance was the price for receiving conditional aid from the USA. The debit balance was like a handicap which had to be earned before the UK could earn gold under EPU, so this was 'negative assistance'. But on the other hand, the UK received grants of assistance from the USA under the 1950 Katz-Gaitskell Agreement, in compensation for gold foregone as a result of pre-quota settlements. The UK also borrowed £89m from the USA's Export-Import Bank in October 1957.

¹¹⁶² Cairncross, *Years of recovery*, pp159-60

¹¹⁶³ This treatment is also consistent with Boughton, 'Northwest of Suez', p435

¹¹⁶⁴ Note that debt service was similarly relieved (amounts of £32m) in Dec/1964 and Dec/1965 (Cairncross, *Managing*, p144). However in this paper, such assistance, being fairly immaterial in the scale of those crises, has not been factored into the figures for these latter years. For the 1964-7 period, assistance has been left as it appears in the literature

The final, most difficult, category of assistance comes under the heading of 'window-dressing'. This was short-term borrowing or asset sales designed to flatter month- or year-end reserve figures. Klug and Smith discovered that in November 1956 the UK reserves were supported by US\$84.5m of 'forward operations including swaps' and by US\$36.4m of 'sale of US Treasury bonds', these latter securities having been held outside the official reserves.¹¹⁶⁵ The difficulty with these types of assistance is, firstly, in identifying them, given that the Bank of England treated them with secrecy; and secondly, in identifying their timing, because short-term borrowing would have to be repaid, and the question is whether the repayment happened inside or outside the full crisis period. Since swaps were ordinarily constructed as UK dollar borrowings collateralised by gold holdings in America (in essence manipulating sales and purchases of gold and the associated value dates in order to create a temporary dollar boost without subtracting the gold), the ledgers for gold dealing on behalf of the Exchange and Equalisation Account (EEA) provide clues to such activity. As a result of reviewing these ledgers, it was decided not to include such assistance in the headline figures given the lack of evidence for a sustained window-dressing effect in other crises, and the risk that some of the window-dressing in 1956 might have been unwound before the crisis finally ended. But since much of the November 1956 window-dressing probably did persist into 1957, the gross amount highlighted by Klug and Smith is included as a supplementary figure.¹¹⁶⁶

¹¹⁶⁵ Klug and Smith, 'Suez and sterling', p189

¹¹⁶⁶ There is uncertainty but there are reasons to believe that the Nov/1956 transactions were exceptional. The comments below offer a brief review of the gold ledgers of the EEA (BOE:2A141/8-2A141/12). The gold ledgers show the UK in particular difficulties during the 1951-2 crisis. Large sales of gold for dollars were made through New York No.1A account from the middle of 1951, and this was supplemented from Oct/1951 with sales of gold for US dollars in the Ottawa account. There probably was some end-Dec/1951 window-dressing, evidenced by a flurry of gold sales for dollars late in that month. The sales continued, but from Feb/1952, most gold sales were recorded as 'Ottawa/New York suspense account', suggesting that gold stocks in America were getting low, with uncertainty about where gold was available for turning into dollars: assistance may have been provided around this time. All gold sales through these accounts then stopped after early Mar/1952. The next transaction was a purchase of gold with dollars in the New York No.1A account in Dec/1952. Given that the period of this crisis ended in Jul/1952, it is reasonable to assume that the effects of assistance would have washed through the reserves before the crisis ended. By contrast there were no particularly unusual patterns in gold sales during the 1955 crisis (the biggest gold for dollars sale was £12.6m equivalent on 19/8/1955), nor in 1957, when gold losses were principally through EPU settlements. During the 1956 crisis, there was some transfer of gold from New York to Ottawa in September, but the unusual gold sales were concentrated in Nov/1956, supporting Klug and Smith's account. Some of this may have been playing with value dates at end-November (there were

Sterling balances of the non-sterling area, 1958-62 and 1962-7

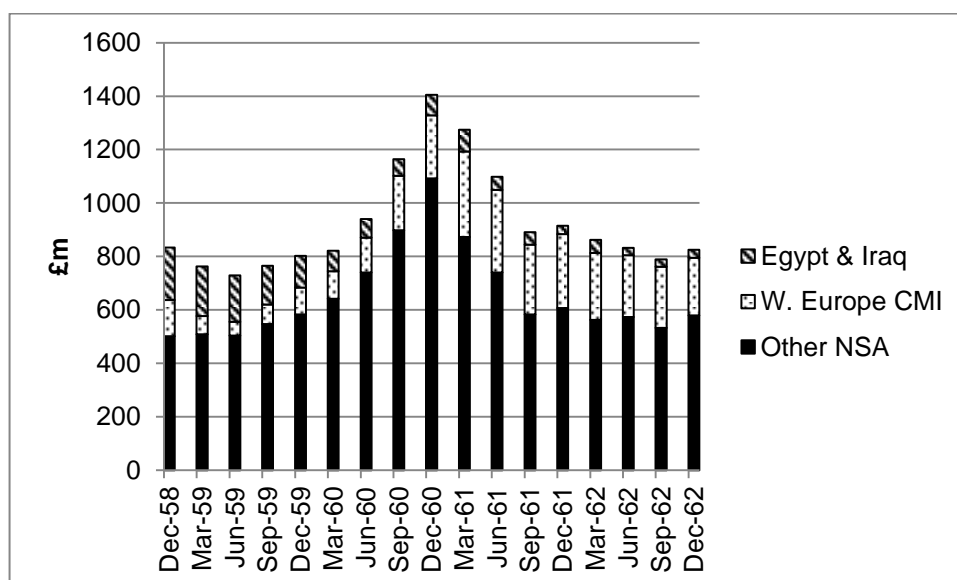


Figure A1: Decomposition of the sterling balances of the NSA countries, showing gross holdings of Egypt, Iraq and Western European Central Monetary Institutions, quarterly at end of quarter, December 1958 – December 1962 (£m)

Source: Net external liabilities in sterling of non-sterling area countries, BOE:Statistical Abstract No.1, 1970, Table 21, p125; gross sterling liabilities of Western European Central Monetary Institutions, Egypt and Iraq, BOE:EID10/3–EID10/6

Note: In the 1958-62 years, assistance to the UK came from Western European central banks, particularly under the Basle arrangements of Mar/1961, and also an IMF drawing in Aug/1961. It is hard to judge the extent to which Western European central banks provided additional assistance to the UK under the auspices of the looser European Monetary Agreement (EMA) which succeeded the EPU. The holdings were now voluntary but they were also supported and incentivised by a UK exchange guarantee (BEQB:1963Q4, p271). At the end of the EPU in Dec/1958, the UK owed £135m to EPU members, which was settled during subsequent years. Sterling balances = net external liabilities of the UK in sterling; NSA = Non-sterling area

£35.5m of gold sales for dollars to the New York No.1A account on 27/11/1956), and some may even have been longer-term agreements (a £17.8m gold sale for dollars on 14/11/1956 was matched by a £17.8m purchase on 28/1/1957). So the Klug and Smith figures may be an overstatement of the assistance to end-Dec/1956, but it is reasonable to treat their gross figure as assistance for this study

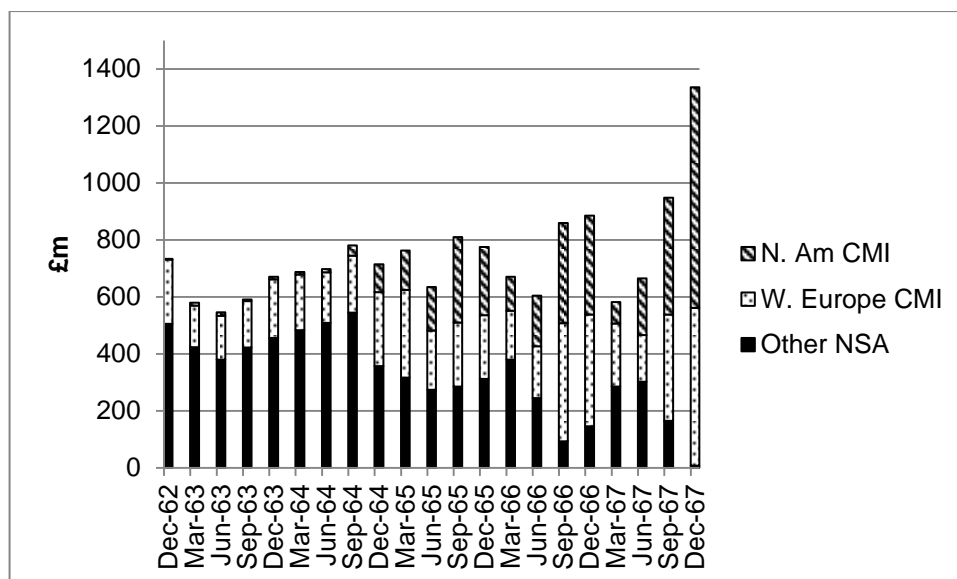
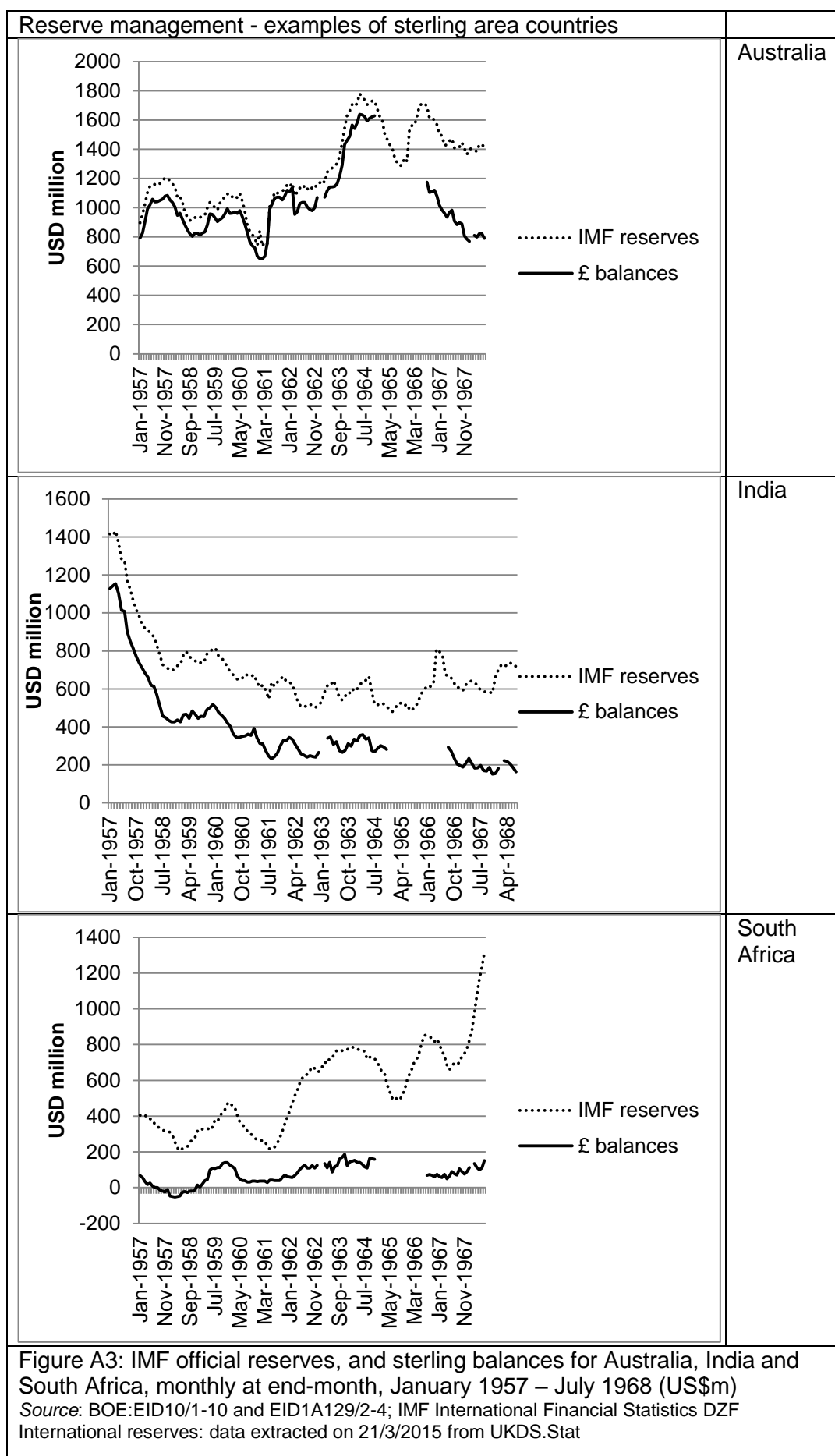
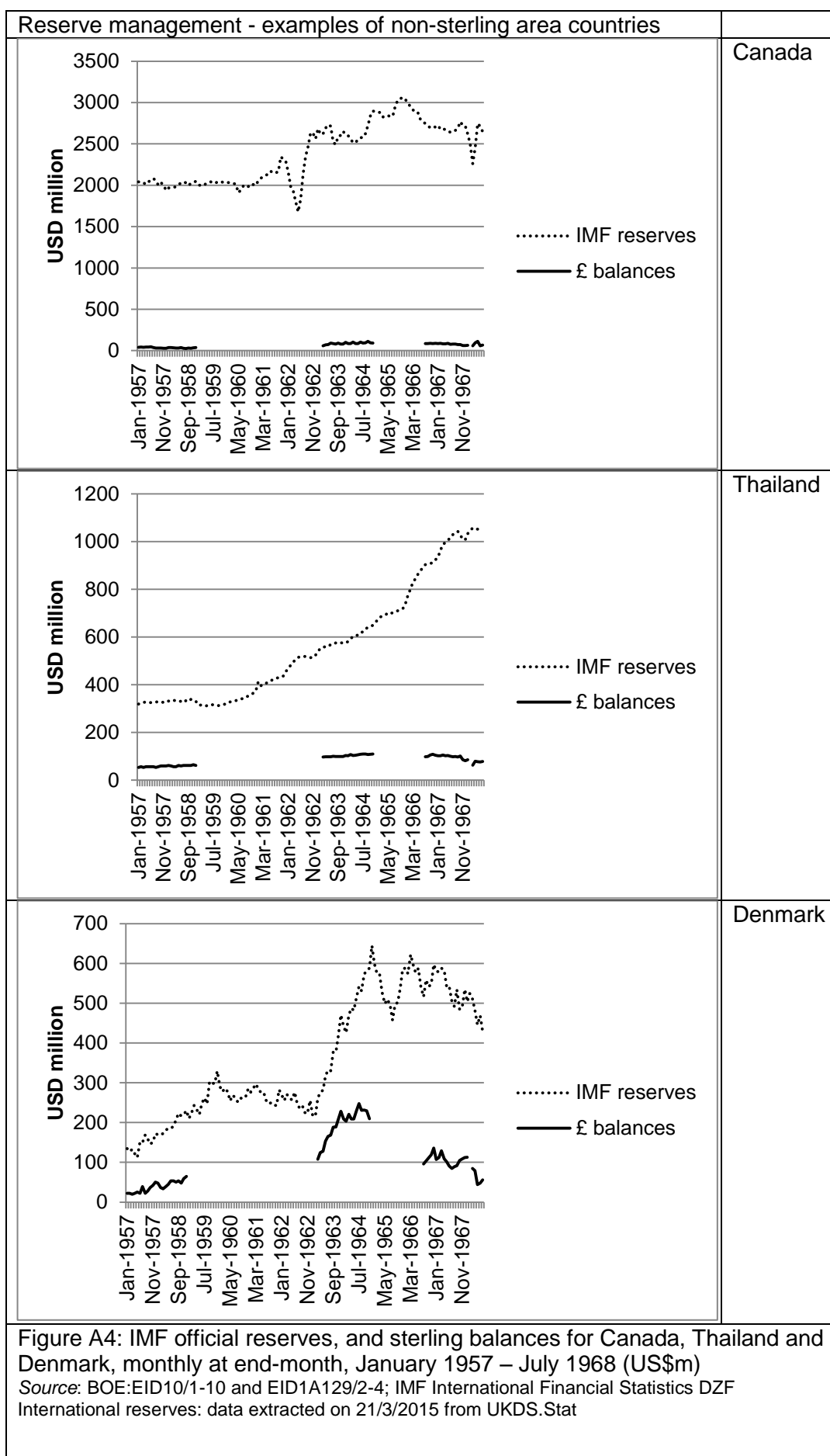


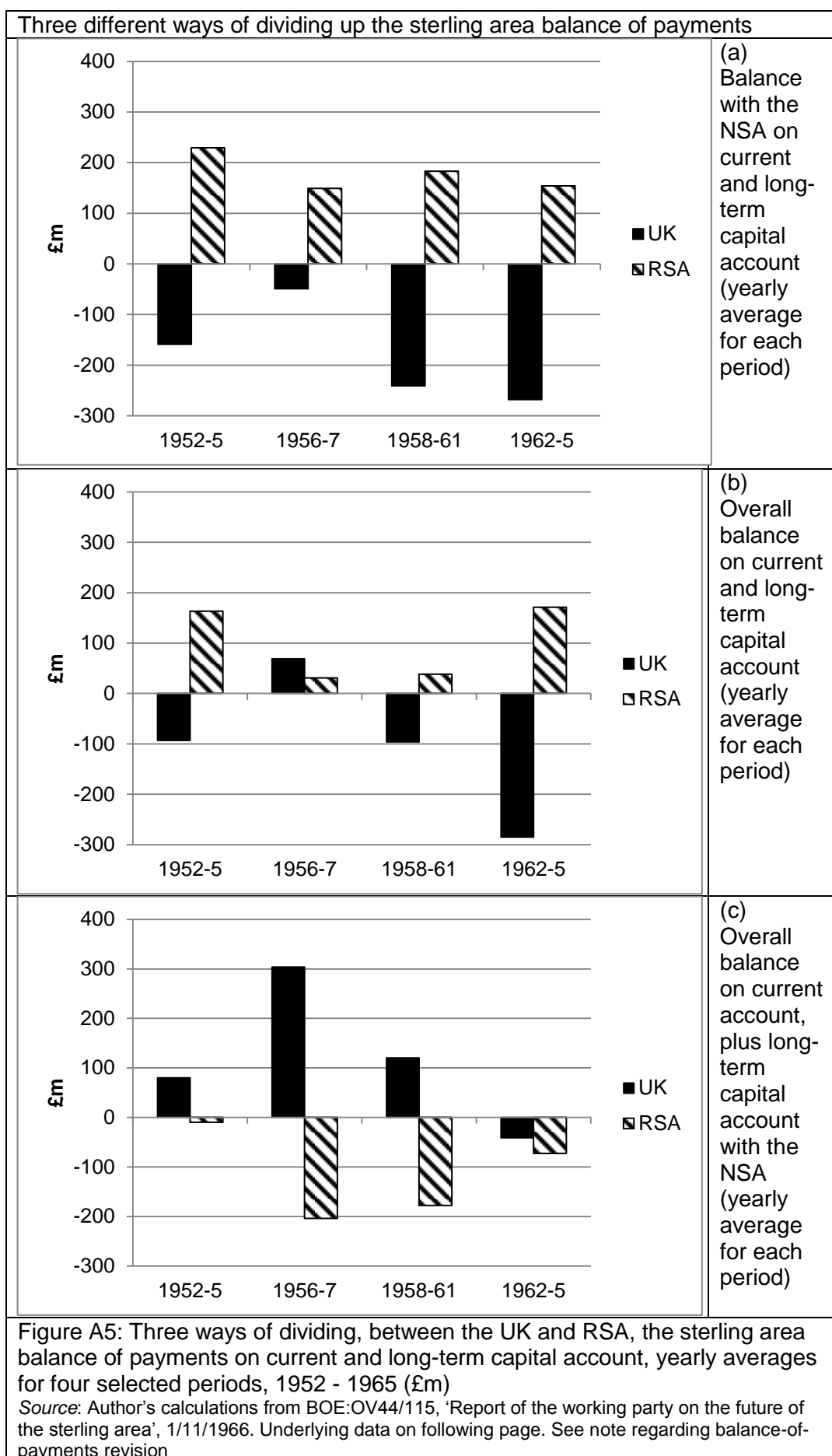
Figure A2: Decomposition of the sterling balances of the NSA countries, showing net holdings of North American and Western European Central Monetary Institutions, quarterly at end of quarter, December 1962 – December 1967 (£m)

Source: Net external liabilities in sterling of all non-sterling area countries, Western European Central Monetary Institutions and North American Central Monetary Institutions, BOE:Statistical Abstract No.1, 1970, Table 22(3), pp139-40

Note: Sterling balances = net external liabilities of the UK in sterling; NSA = Non-sterling area







	Balance of payments			
Yearly average (£m)	UK with NSA	UK overall	RSA with NSA	RSA overall
1952-5				
Current balance	-172	+67	+101	-138
Long-term capital	+13	-160	+128	+301
Balance of current and long-term capital	-159	-93	+229	+163
1956-7				
Current balance	-137	+216	-25	-378
Long-term capital	+88	-147	+174	+409
Balance of current and long-term capital	-49	+69	+149	+31
1958-61				
Current balance	-313	+48	-195	-556
Long-term capital	+72	-144	+378	+594
Balance of current and long-term capital	-241	-96	+183	+38
1962-5*				
Current balance	-299	-72	-454	-681
Long-term capital	+31	-213	+608	+852
Balance of current and long-term capital	-268	-285	+154	+137

Table A3: Three ways of dividing, between the UK and RSA, the sterling area's balance of payments on current and long-term capital account, yearly averages for four selected periods, 1952 – 1965 (£m)

Source: BOE:OV44/115 'Report of the working party on the future of the sterling area', 1/11/1966. The three ways correspond to those reviewed in Scott, 'The balance of payments', pp211-2

*Note: There are doubts over accuracy of the figures for the 1962-5 period, because of the subsequent revision of UK balance-of-payments data. Prior to the revision, balance-of-payments figures overstated the UK balance-of-payments deficit due to the under-recording of exports. See Thirlwall and Gibson, *Balance-of-payments theory*, pp238-9

Sterling balances - gross and net liabilities, by type of holder, 1962-7

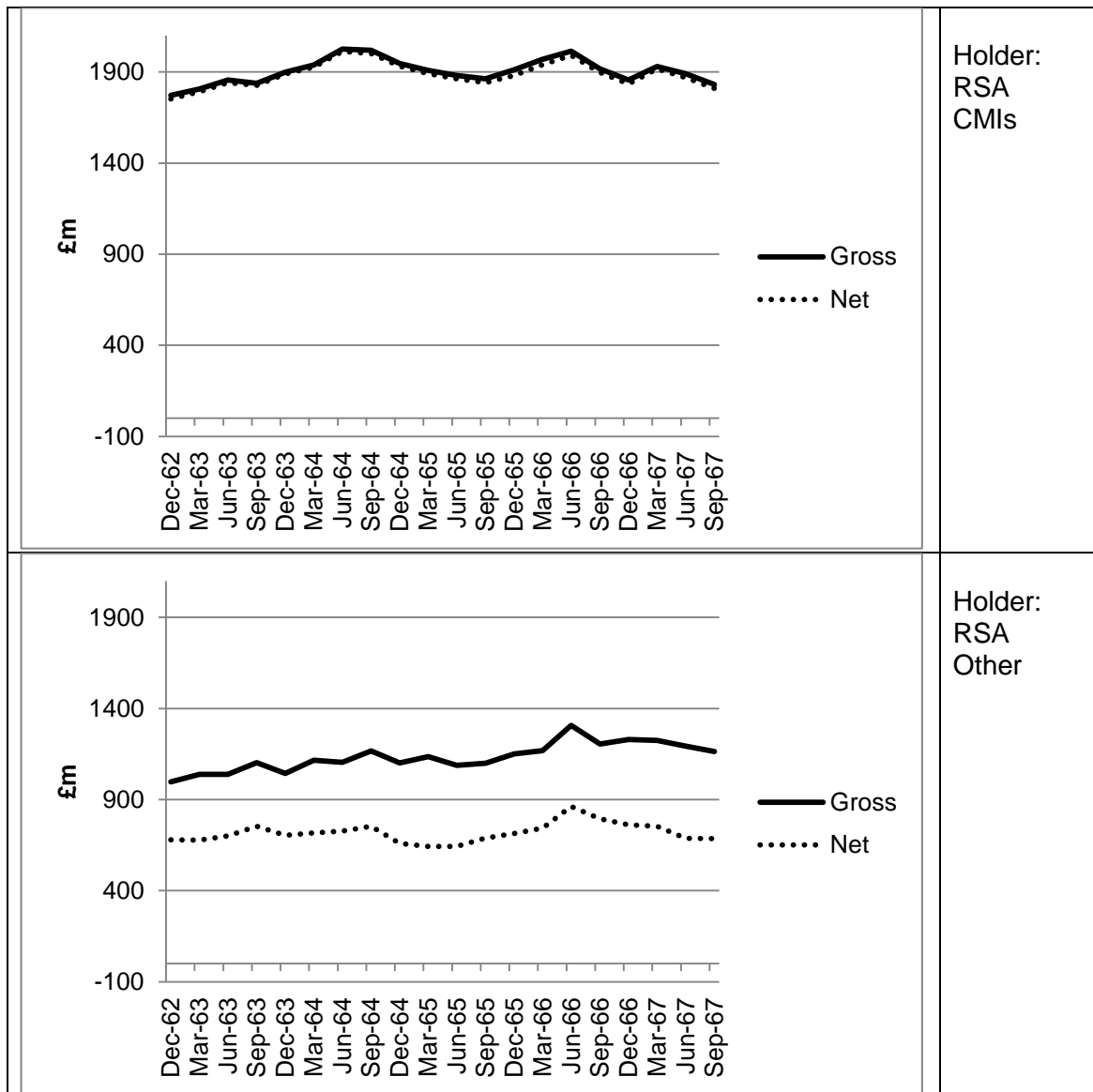


Figure A6: Sterling balances by type of holder: RSA countries, gross and net of claims, quarterly, 31 December 1962 – 30 September 1967 (£m)

Source: BOE:Statistical Abstract No.1, 1970, Table 22(2), pp134-8

Note: Sterling balances = Net external liabilities of the UK in sterling; RSA = Rest of the sterling area

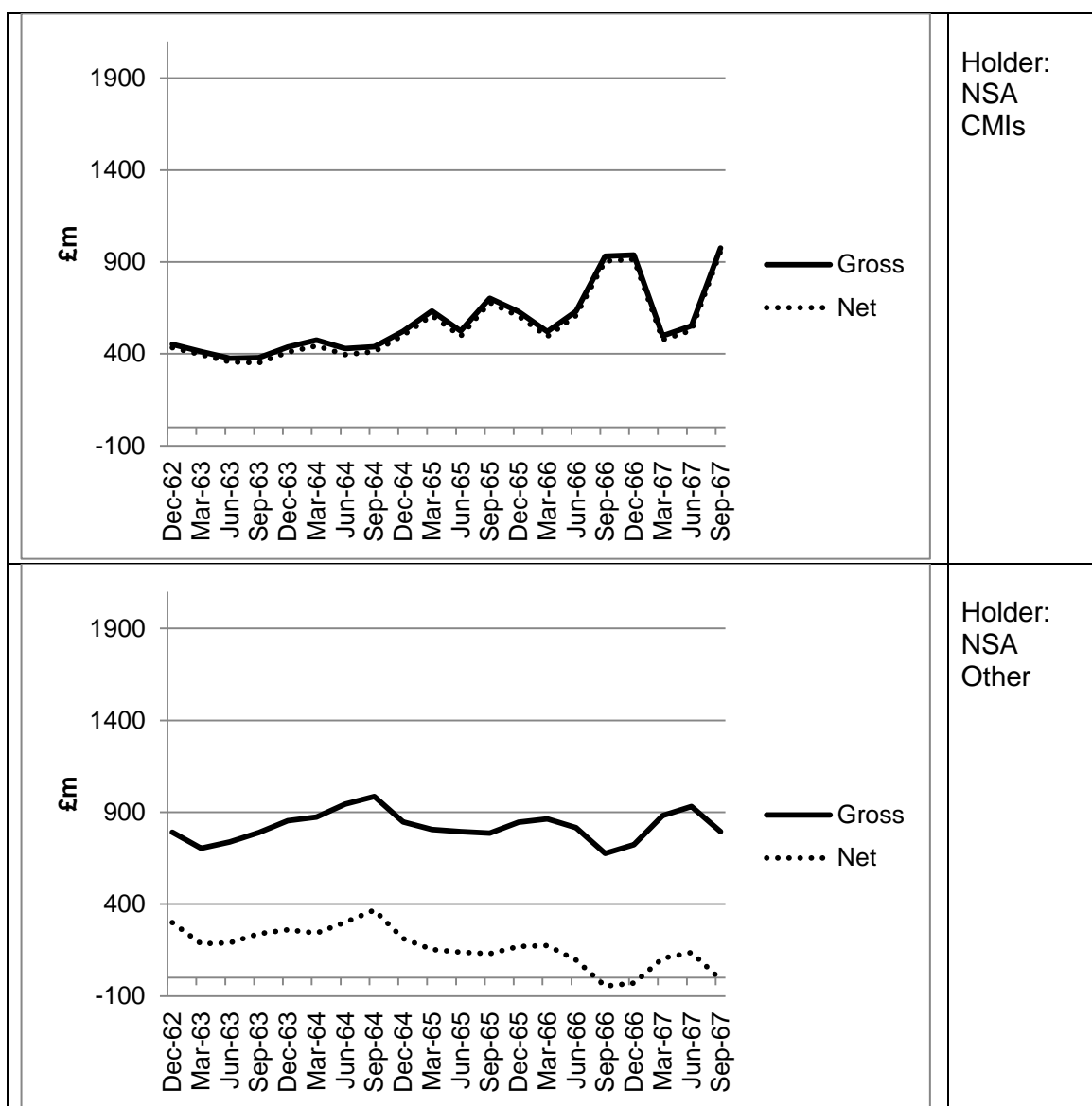


Figure A7: Sterling balances by type of holder: NSA countries, gross and net of claims, quarterly, 31 December 1962 – 30 September 1967 (£m)

Source: BOE:Statistical Abstract No.1, 1970, Table 22(2), pp134-8

Note: Sterling balances = Net external liabilities of the UK in sterling; NSA = Non-sterling area

Chapter 5. Conclusion

1: Did the sterling area matter?

The three separate studies included in this dissertation deal with the sterling area monetary and exchange system of the 1950s-60s. Whereas these papers address various themes relevant to the sterling area historiography, they all show that the institutional organisation of the sterling area had significant financial implications for both the United Kingdom and independent member countries as well as for the role of sterling as an international reserve currency. The three case studies presented above have shown how the institutions of the sterling area had important consequences for reserve management and central bank development in member countries, as well as for the position of the pound sterling during episodes of currency crises. The sterling area system was not an empty shell: its rules, practices and organisational set-up 'mattered' for the evolution of the pound sterling and international monetary system during the 1950s and 1960s.

This finding nuances conclusions of the existing historiography on the sterling area. Most authors have attributed the persistence of sterling in international reserves during the 1950s-60s either to loyalty towards the UK¹¹⁶⁷ or economic self-interest¹¹⁶⁸ or external support,¹¹⁶⁹ and argued that sterling crises were purely driven by the UK's balance-of-payments problems. While these factors certainly played an important role, the three studies show that they are not the full story. The case of Australia in 1950-68 reveals that international reserves composition was not solely driven by transactions (currency peg, trade and debt) and risk-return considerations, but that the precise institutional rules of the sterling area system also mattered crucially for how reserves were being managed in the independent member countries. These rules also helped to

¹¹⁶⁷ Eichengreen, *Global imbalances*, p134

¹¹⁶⁸ Singleton and Schenk, 'The shift'

¹¹⁶⁹ Schenk, *The decline*

delay the decline of sterling as an international reserve currency. Similarly, Ireland's transition from a currency board to a central bank in the 1960-70s was not just the consequence of a natural, gradual evolution of the financial system in a country characterised by close cultural and economic ties with the UK, but this transition was precipitated by changes in the rules and organisation of the sterling area system following the pound's devaluation of 1967. Finally, while the UK's own balance-of-payments problems played an important role in the numerous sterling crises of the 1950s and 1960s, an analysis of nine UK currency crisis episodes over the years 1950-67 suggests that reserve movements in other sterling area member countries may also have contributed to amplify these crises. Speculative attacks on the pound sterling were not only driven by the UK's fundamental weaknesses but also resulted from the balance-of-payments problems of the sterling area as a whole.

Another common finding in each of these three studies is that sterling's international role in the 1950s-60s was highly dependent on the sterling area. The use of the pound as a reserve currency would have been very limited without the rules of the sterling area system – such as the exchange control rules regarding intra-sterling area trade settlement – which determined RSA countries' sterling reserve holdings. In particular, the three papers reveal the prevalence, consistency and longevity of reserve pooling within the sterling area. This is in contrast to some claims in the literature that reserve pooling had come to an end with the advent of sterling convertibility. Logically, convertibility seemed to remove the need for a sterling area or pooling system. But in fact, diversification away from sterling by the sterling area countries was limited until the crisis of 1964; it was constrained in Australia; and in Ireland the few acts of diversification seen in the 1950s had been driven by technical considerations (a shortage of sterling assets in one part of the central bank). The importance of this reserve pooling for the UK is even more apparent when one appreciates, through the sterling crises chapter, how limited were the sterling holdings of non-sterling area

countries once assistance to the UK (e.g. through the EPU) is excluded. Therefore, the pound sterling was, in this sense, an international currency which was artificially supported, by a combination of sterling area rules (informal constraints), UK capital exports and the liberal provision of trade credit from London, and assistance from the non-sterling area. This explains the persistence of sterling as an international currency.

If one examines Australia's reserve management in detail, one finds that it was following the sterling area's reserve-pooling rule closely. Sterling was the sole transactional currency; other reserve assets formed a rainy day fund. Acquisition of those other assets for risk-return reasons was not that of a free portfolio manager, but constrained to the opportunities consistent with acceptable or negotiated sterling area practice, such as gold production and the build-up of the IMF gold tranche, and reversed by minimum sterling needs during Australian crises in 1951-61. Australia held far fewer US dollars than its economic transactional orientation (trade, debt, and its direct dollar deficit) would justify, and it did not use them for transactions. Reserve pooling and the UK's sterling area system suited Australia, allowing it to acquire sterling from net exports to the non-dollar non-sterling area and use this sterling to finance net purchases in the dollar area and the UK.

Similarly, Ireland followed the sterling area's reserve-pooling rules closely until the devaluation of 1967. Again, this suited Ireland, which could thereby finance its net imports from continental Europe with its net inflow from the UK and USA. One might want to attribute such transactional behaviour solely to Ireland's sterling-based currency board system, but, if so, why did Ireland, with the same currency board system and sterling transactional needs, seek to diversify away from sterling so aggressively after the devaluation? It was not only because Irish officials perceived new sterling risks, for they were already, in 1965-7, concerned about the risk of devaluation. Irish officials refrained from diversification prior to devaluation, as they

said, because they perceived an implicit sterling area contract with the UK. In 1968, they took sterling's devaluation to have been a breach of contract, so the old rules no longer applied. In Ireland's financial system, reserves were decentralised and held by commercial banks which prized sterling liquidity given the lack of a money market in Ireland. The pre-devaluation sterling area system did not encourage Ireland's financial development, and this decentralisation of reserves also hindered diversification. The devaluation set in train a chain of events which led both to the centralisation of those reserves in the central bank in 1968-9, and the development of an Irish money market in the 1970s.

Looking at sterling crises of the pre-devaluation period, defined by the historical literature and measured in losses of the UK's free reserves (net of assistance), one also finds considerable adverse movements in the sterling reserves of the sterling area countries – caused by balance-of-payments deficits in the crises of 1951-64 (albeit, in 1961, mainly preceding the crisis, and buttressed by an Australian IMF drawing) – and diversification away from sterling in 1964-7. In the crises of 1951-2, 1955 and 1957, these adverse movements were large relative to other elements of the UK's balance-of-payments accounting identity underlying the decline in free reserves. This is not conclusive evidence that the sterling area's deficits exacerbated, or caused, the UK's reserve crises. This depends on one's view of the methodology: there were rival mental models which were used both at the time and in the more recent historiography to assess this question. But it contradicts the statements of commentators who denied any possible role for these sterling reserves in particular crises and claimed that the balances were stable and illiquid.

The fact that the sterling area mattered crucially for both financial decisions in the independent member countries and the role of sterling as a reserve currency has important implications for our understanding of international currencies. Scholars have

long debated what factors can account for the rise and decline of international reserve currencies. In particular, they have discussed the significance of network externalities, economic size, and risk-return trade-offs in countries' choice of the currency composition of their international reserves. The history of the sterling area also suggests that, in a world of competing international currencies, financial alliances matter to aggregate reserve holdings and make a difference to a currency's international status.

2: Conclusions for the economic literature

Chapter 1 reviewed the economic literature surrounding reserve management, highlighting supply and demand considerations, and, within the latter, the mean-variance and transactions theories underlying international reserve holdings. There was a strand of the supply literature highlighting the costs of operating a reserve currency in decline. Although inconclusive, the crises chapter helped to illuminate how such costs might have arisen, as a decline in sterling reserves held internationally fed through to losses of UK reserves either more directly, through drawings on the dollar pool and spending in the non-sterling area, or indirectly, through the inflationary consequences of excess spending in the UK.

With regard to the currency composition of foreign exchange reserves (COFER), all three papers unsurprisingly found strong evidence for transactional and risk-return drivers in reserve management. Both Australia and Ireland were found to be rather immersed in sterling transactions (Australia more so than the sterling area literature had indicated, due to new evidence about the currency of international payments). Indeed, through reserve pooling, sterling was their sole transactional currency. If dollars were required, sterling would normally be used to purchase the dollars and the existing dollar holdings would not be drawn down (save on a few specific occasions

such as during reserve crises in the case of Australia). While it could possibly be argued that the completeness of sterling's transactional use was attributable to the implications of a sterling peg rather than reserve pooling, such a counterargument would not seem consistent with the transactions literature, which also attributes currency choice to trade and debt factors; nor does it explain why Australia's gold production was allowed to augment its gold and dollar holdings, rather than being converted into sterling along with everything else. This behaviour was, by contrast, entirely consistent with the practice of reserve pooling in the sterling area.

Dooley, Lizondo and Mathieson (DLM) theorised that countries would manage the risk-return aspects of COFER through their net asset position, and transactions needs would drive their gross assets.¹¹⁷⁰ In practice, this did not seem to be the case in Australia and Ireland. In Australia, assets and liabilities were managed in different cities by rival organisations. At the central bank in Sydney, there was great concern expressed about the risk-return balance of the gross assets, despite the existence of natural hedges in the liabilities. This may have reflected a desire to avoid losses within that organisation. And, for the Treasury in Canberra, access to the sterling bond market was restricted towards the end of the period, so the share of sterling in the liabilities decreased even as the risks of holding sterling increased. Ireland at first had no external liabilities, and, while the net asset position clearly influenced COFER, Irish policymakers found in 1966 that their country's access to the sterling debt market was curtailed by the British authorities. They had to resort to borrowing in other currencies, and did not respond on the gross assets until 1968.

The literature has argued that the organisational form and governance of the reserve manager influences whether profit-maximisation is prioritised over other objectives in reserve management. The central banks in Australia and Ireland (and most sterling

¹¹⁷⁰ Dooley, Lizondo and Mathieson, 'Currency composition'

area countries) had private histories but were now state-owned. While the Australian central bank performed some commercial activities in the 1950s, this did not seem to alter its state mission and character, which had been established long before the 1950s. Both central banks were distinct organisations with balance sheets and some profits that were retained. So they were sensitive to profit opportunities (e.g. the extra yield available from longer-term gilts over shorter-term Treasury bills), but fundamentally risk-averse, and concerned with protecting the size of the international reserves and avoiding losses. Both considered their reserves inadequate relative to the demands that might be required of them. While aligned with government objectives, both pushed back against government policies which consumed or threatened those resources: but the governments were stronger. Both were also engaged in power struggles with the commercial banks, which were combative in Australia and entrenched in Ireland: the central banks increased their power and reached an accommodation with the commercial banks, but it was a protracted process, particularly in Ireland. The situation in the UK was slightly different. Although state-owned, the Bank of England enjoyed more independence and power by virtue of its privileged access to information and role in market intervention, and its pivotal position within the sterling area as a whole.

The literature has also argued that the adequacy of reserves will determine whether transactions or risk-return drivers prevail in risk management: inadequate reserves demand a transactions approach. The cases of Australia and Ireland support this view. Both central banks prioritised minimum sterling transactional needs, leading Australia to sell gold and dollars during reserve crises (undermining the policy set in 1951 to accrue gold production in gold or dollar form), and Irish central bank Governors of the 1950s-60s to focus on the core mission of preserving the value of the Irish pound against sterling, resisting government and other pressures to diversify, due to the inadequacy of sterling reserves. Through reserve pooling, sterling was these countries'

sole transactional currency, so all other holdings effectively reflected a risk-return view. High levels of sterling in reserves thus revealed, indirectly, the importance of transactional needs. Organisational considerations also mattered, however. In the Australian central bank, a restriction on US dollars in the Note Issue Department may have caused technical complications in conjunction with other policies. Heller found that aggregate reserves in Ireland (unlike in the UK and Australia) were more than adequate.¹¹⁷¹ However, because of the decentralisation of those reserves, and the division within the central bank between the Legal Tender Note Fund and the General Fund, the central bank felt unable to perform its functions, and in the commercial banks, concerned with credit growth, liquidity and the general convertibility of the Irish pound into sterling, sterling liquidity was under pressure by the end of the 1960s. A good depiction of reserve management in the sterling area can be based on the sub-fund approach of Naameh.¹¹⁷² There was an illiquid fund (all sterling) representing minimum reserve needs. There was a liquid fund (all remaining sterling) for transactions. And there was a 'rainy day' fund (all other reserve assets) held for insurance purposes.

Other issues in the recent economic literature include trade invoicing and FX liquidity e.g. the costs of dealing. If invoicing does drive currency shares, as argued by Ito, McCauley and Chan,¹¹⁷³ then the sterling area's rules and policies, specially designed to maximise sterling trade settlement, were well-targeted. Somewhat contrary to Eichengreen, Chitu and Mehl's argument about switching costs,¹¹⁷⁴ the evidence in the Australian archives did not suggest that FX dealing prices were uncompetitive for a sterling area country under Bretton Woods – the Bank of England often intervened to provide execution in the middle of the market – nor was Australia restricted in its use of the dollar pool. Fixed exchange rates logically may even have reduced some practical

¹¹⁷¹ Heller, 'Optimal international reserves'

¹¹⁷² Naameh, 'Reserve management'

¹¹⁷³ Ito, McCauley and Chan, 'Currency composition'

¹¹⁷⁴ Eichengreen, Chitu and Mehl, 'Stability or upheaval?'

dealing costs since there was less intraday FX price volatility. The drawback, acknowledged by officials, was that such dealing in London was undertaken under the gaze of the UK authorities. The Bank even had intelligence of what the Irish central bank was doing in New York.

Chapter 1 also considered the literature surrounding international rules, agreements, institutions and monetary co-operation. It is apparent that the sterling area's rules were informal constraints (in the language of North),¹¹⁷⁵ with only mixed evidence of enforcement (intra-sterling area settlement being a likely exception). They were more long-ingrained bargains than conventions. These rules can only be interpreted (as McKinnon interpreted the rules of Bretton Woods).¹¹⁷⁶ McKinnon's rules provide a framework for the challenges faced by the sterling area, but logically they must be applied to the sterling area as a whole entity, not just to the UK. The same comment applies to the Mundell-Fleming monetary trilemma. The sterling area as a whole entity lacked policy credibility because there were no common policies designed to address the recurring balance-of-payments deficits of the whole sterling area. Bordo and Schenk argued that the lack of monetary policy credibility at the individual country level undermined Bretton Woods.¹¹⁷⁷ The problem was compounded in the sterling area because of the inflationary incentives built into the co-operative mechanism of reserve pooling against a policy background of growth and development.

The sterling area can be characterised as a discriminatory regional arrangement comparable to the Gold Pool and the EPU. But it was informal, lacking the administrative underpinnings of these two institutions. Eichengreen highlighted six problems with the Gold Pool.¹¹⁷⁸ The sterling area shared some of these (no shared diagnosis of the problem, non-compliant free riding, incompatibility with Bretton

¹¹⁷⁵ North, *Institutions*

¹¹⁷⁶ McKinnon, 'The rules'

¹¹⁷⁷ Bordo and Schenk, 'Monetary policy cooperation'

¹¹⁷⁸ Eichengreen, *Global imbalances*

Woods, lack of transparency) but was slightly stronger in other respects. There was at least an implied enforcement mechanism (the diversity of bilateral relations with the UK, such as military support, the London capital market and the UK's consumers), and there was longer-term stability between the UK's sterling liabilities and international reserves (no obvious Triffin problem). With its core-periphery structure, the UK being naturally reluctant to cede decision-making over its currency to others, the sterling area did not match the problem resolution and symmetrical policy co-ordination evident in the EPU. Above all, its aims were less well-defined and changed over time.

The sterling area also matched closely Lipson's description of informal international agreements.¹¹⁷⁹ The difficulty of reaching a common balance-of-payments policy suggested a need for informal agreements, substituting for formal ones. Because they were informal, they were unreliable, and the tacit agreements were sometimes broken. There were misunderstandings about tacit rules – for instance, Australian anger about the EMA guarantees, despite a long history of the UK providing guarantees to non-sterling area countries (but not to sterling area countries, which were expected to trust in sterling). The sense of betrayal in reaction to the UK's devaluation of sterling in 1967 suggested a tacit agreement that the UK would not devalue: violation of a perceived bargain, as illustrated by Ireland's changed reserve management behaviour before and after devaluation. However, tacit agreements enjoyed a key advantage in relation to the formal rules of Bretton Woods. They allowed a discriminatory currency system, in which US dollars were forbidden in the settlement of intra-sterling area trade, to persist within a wider dollar-based system that insisted upon non-discrimination.

¹¹⁷⁹ Lipson, 'Why are some'

3: Conclusions for the sterling area literature

Chapter 1 addressed three aspects of the sterling area literature. The first related to the perceived disconnect between the sterling area's discriminatory purpose, rooted in British exchange controls and non-convertibility, and its lack of a *raison d'être* after the achievement of sterling convertibility. It is clear from all three papers, in contradiction of some authors, that sterling area reserve pooling remained widespread and persisted through the 1960s. This may have reflected the fact that, while convertibility had been achieved, there was always the possibility, in extremis, of a return to non-convertibility, so the old mechanisms were retained.

The second aspect was that of rules, or working practices. With regard to the sterling peg, this was a rational and natural choice for Ireland. It was rational too for Australia, and preferred to dollar pegging, given the priority of full employment. But in Australia, while policymakers indicated that they might follow sterling in a float, they were sensitive to its amplitude, had an eye on the parity with the US dollar, and had a preference for generally fixed exchange rates given the importance of counter-inflationary policy. In other words, Australia's support for the sterling peg was conditional on its general stability against other currencies. Other countries, e.g. India, Pakistan, and Ceylon, might well not have followed sterling in a float. This suggests that, if sterling had floated in the 1950s, as proposed by Burnham,¹¹⁸⁰ this could have led to an early break-up of the sterling area, and a resulting exchange crisis.

The thesis has also highlighted the importance of certain sterling area controls, such as the hard rules regarding intra-sterling area settlement. These were acknowledged by the literature, but without great prominence. However, Australia's case showed how the effect of such rules and London's trade credit support for sterling was to immerse

¹¹⁸⁰ Burnham, *Remaking*

Australia in sterling area transactions. By the early 1960s, sterling's share of Australia's payments was three times that of the UK's share in its payments.

Chapter 1 also drew comparisons between the sterling area's pooling arrangements and more recent regional pooling schemes. As the Australian case showed, the sterling area shared the economising, risk-sharing benefits of reserve pooling, but also the weaknesses evident in the reserve-pooling literature, namely costs and benefits which were not shared equally, and inflationary incentives. Australia was an early beneficiary of reserve pooling given its direct dollar deficit: its manifest commitment to reserve pooling was rational. But there was a particular problem in the sterling area. Because of the different ways in which 'contributions' were measured (viz balance-of-payments debates between authors such as Wright and others such as Kamarck, Scott and Zupnick),¹¹⁸¹ there was little clarity or agreement about which countries were contributing. Australian officials regarded Australia as a net contributor due to its trade surplus with the non-dollar non-sterling area. These different 'mental models' were highlighted by the crises chapter: in effect they pervade the contemporary and historical literature. If all members of a pooling system regarded themselves as having either moral claims (due to 'contributions') or claims of need, then the consequences were likely to be inflationary.

All three papers also addressed, directly or indirectly, co-operation within the sterling area, where there were different views in the literature about the extent of co-operation. The findings were that co-operation was largely limited to shallow co-operation (information-sharing) and reserve pooling. Ireland did not diversify majorly until after the 1967 devaluation, and Australia's diversification was limited and constrained to opportunities that were consistent with sterling area accepted practice, or unobtrusive. Despite much concern on the British side with the diplomacy of 'gold

¹¹⁸¹ Wright, 'Dollar pooling'; Kamarck, 'Pooling: comment'; Scott, 'The balance of payments', 'What should be done'; Zupnick, 'The sterling area's'

and dollar pots', sterling area diversification only became a general problem with the crises of 1964-7. The sterling crises chapter revealed the extent of that later diversification, which was significant. The Australia and Ireland chapters also showed major policymaker concern regarding the risk of sterling devaluation, from early in 1965.

The third aspect of the sterling area literature was the 'sterling balances', and within that subject, the three issues of the wartime accumulations, the volatility of the balances, and diversification (switching from sterling to gold, dollars or other reserves). The last of these we have just discussed. The broad view of the literature was that the wartime accumulations were well on the way to resolution by 1950. Certainly much recycling had occurred, but the crises chapter showed that there were still, in the 1950s, significant sterling reserves held by countries such as India and Egypt, which contributed to declines in the sterling balances during crises, even into the early 1960s.

The big debate highlighted in Chapter 1 was that between the 'critics' such as Shonfield,¹¹⁸² and contemporary defenders and a later more revisionist historiography, regarding the liquidity and variation of the sterling balances and the consequences for the UK reserves. The Australia chapter found, in parallel to Schenk's findings for the colonies, that there was a significant illiquid element to Australia's reserves (of the order of £200m, as Schenk had originally observed),¹¹⁸³ and importantly explained *why* those reserves were illiquid (policymakers' need for minimum sterling holdings). On the other hand, Australia's sterling reserves ranged, with its balance of payments, between around £200m to £600m, so there was a large liquid element too. The crises chapter also found significant declines in the sterling area's sterling reserves during or around the crises of 1951-64. Whether those declines contributed to losses of UK reserves remains moot, and conditional on the rival methodologies for examining this question.

¹¹⁸² Shonfield, *British economic policy*

¹¹⁸³ Schenk, *Britain*

But privately, despite assurances made externally, the Bank of England was concerned about the connection and correlation between the sterling balances and the UK's reserves. The relevant (net of assistance) monthly correlations between the UK's external sterling liabilities and reserves were high (80 per cent) in the 1950s. The principal source of crises against this background was the inadequacy of UK reserves, ranging between around £600m and £1,200m.

The Australia case also revealed that, during the sterling crises of 1964-8, policymakers were sensitive to switching out of sterling (diversification), but, at the same time, relaxed about spending sterling reserves for balance-of-payments reasons, so long as sterling reserves were above those minimum levels. Given that policymakers would have been well aware of the 1940s-60s debate around potentially adverse effects, on sterling, from the spending of sterling (Hirsch named such 'conversion' as one of three factors contributing to sterling crises),¹¹⁸⁴ the relative indifference towards spending suggests that they might have been motivated more by sterling area rules (where switching was discouraged, spending was allowed) than by self-interested concerns about the effect of that spending on the price of sterling (a 'sterling trap').

Finally, Chapter 1 considered the literature's distinction between official and private holdings both within and outside the sterling area, and different interpretations of the private holdings: some authors equated stable and increasing private holdings in the sterling area with traders' 'working balances' and international confidence in the commercial use of sterling, as opposed to its official, reserve currency use. The crises chapter highlighted how the UK authorities promoted the idea that sterling was returning to its pre-war voluntary, commercial role, and promised continued support for that role. It also revealed, however, that much of the holdings of the non-sterling area

¹¹⁸⁴ Hirsch, *The pound sterling*

took the form of assistance to the UK, and the residual confidence holdings were limited and volatile. The Australia and Ireland chapters provided an opportunity to consider the nature of private holdings within the sterling area. Due to Australian exchange control rules, the private holdings of sterling were simply those of the trading banks, acting as mobilisation agents for the central bank. In Ireland, the private holdings recorded in the 'sterling balances' were the liquidity reserves of the major commercial banks, and designated 'official reserves' within Ireland. The correctness of this description was shown when these holdings were indeed centralised at the CBI in 1968-9. In other words, these sterling holdings were not traders' 'working balances' and did not reflect commercial confidence in sterling, they were just another form of 'official' holding.

4: Conclusions from the three papers

Above all, it should be emphasised, the three papers address different questions. Although the aim of this conclusion is to unify them, I would encourage the reader to address each paper as a standalone study. The papers reveal that the simple alternative stories are not wrong as approximations – Australia's reserve management was driven by transactions and risk-return considerations; Ireland's central bank was based around a currency board; sterling crises *were* driven by speculation and UK balance-of-payments weaknesses. But at the level of detail, these explanations miss *how* Australian reserve management operated and *when* the direction of policy changed (i.e. in 1962, after the UK's application to join the EEC); *why* Ireland diversified and centralised its reserves in 1968-9; and what was happening to the sterling area's sterling reserves during the sterling crises of the 1950s-60s.

The microeconomic details matter. Because the detail has not been understood, some false claims have been made, as discussed in the papers. An example is the idea that

Australia supported the sterling area through 'gifts of gold' e.g. during the Suez crisis. In fact, it was simply shoring up its sterling holdings in order to meet minimum sterling needs. In the case of Australia, in order to understand how reserve management operated, it is necessary to understand the mechanism of reserve pooling, gold production and GPA sales, the IMF gold tranche, other more limited forms of diversification (e.g. retention of loan proceeds), balance-of-payments volatility, minimum sterling needs, the London funds and the Note Issue Department, the rules of sterling area trade settlement, flight capital from the UK, the lack of a foreign exchange market etc. There is no previous account, in the literature, of the interaction of all these factors.

In the case of Ireland, in order to understand the centralisation and diversification events (of which this is the first detailed account), it is necessary to understand the tensions within the tripartite financial system, and debates within government and central bank and with the commercial banks and the UK government. The sterling area system in effect deterred diversification (through a perceived bilateral contract) and hindered centralisation and financial development (since commercial banks could rely on London as a repository for their liquidity). These inertial effects were also self-reinforcing e.g. decentralisation of reserves further deterred diversification. Sterling's devaluation, combined with increased liquidity stresses among the commercial banks, changed the environment, and set off a chain of events which produced the diversification and centralisation. The central bank's currency board was orthodox in a narrow sense, but did not prevent commercial banks from lending increasing amounts to the government. It was no doubt a source of some inertia, but cannot explain what happened in 1968-9.

Thirdly, the literature surrounding sterling crises has tended to focus on the potential risk of speculative runs on the pound, whether by countries within or outside the

sterling area. Perhaps this focus reflects the confidence concerns of the Triffin dilemma, or the currency crisis literature. However, given that reserve pooling was largely followed, this was a misdirected concern for the sterling area, at least until the 1964-7 period. During the crises of the 1950s, there were relatively large declines in the sterling area's sterling reserves, which derived from balance-of-payments deficits. Whether these contributed to the crises is inconclusive. But examining the details of the contemporary debates reveals the different mental models employed by critics and defenders of the sterling area system. The same arguments are also recognisable in more recent historiography, so the institutional effect of the sterling area on the UK's exchange crises remains an unresolved question.

In short, the longevity of reserve pooling, the importance of the UK's implicit promise not to devalue the pound, the problems posed by the sterling area's balance-of-payments deficits, and the sheer complexity of the institutional apparatus surrounding the sterling area, from the organisational set-up of central banks to the rules of trade settlement, are the principal findings of this thesis.

5: Wider applications?

Apart from a desire to understand the sterling area system, and to fill study gaps within the sterling area historiography, this thesis was motivated by an interest in international currencies in a multipolar world, and the potential impact of financial alliances. Today's international currency system is a different world, dominated by capital flows. Still, the sterling area system was a remarkable construction which was able to change reserve management behaviours in a major way (as seen in the difference between sterling area and other countries), and so allowed sterling to punch well above the UK's weight in the international monetary system throughout the 1950s-60s. For a quarter of a century, the sterling area managed to discriminate against the US dollar within a

multilateral rule-based system that was centred on the dollar. Its informality (and US forbearance) protected it from challenge. But it was not as lax as it seemed and its members, on the whole, adhered to its rules.

It had its weaknesses too. Contrary to nostalgic views of the decades before Britain's membership of the European Community, the sterling area was far from being a golden age of Commonwealth co-operation. In this period, the UK discovered that being a reserve currency issuer is not always a privilege. However, the greatest difficulty lay in Britain's inability to end its role as banker to the sterling area. As Fforde, chief cashier at the Bank of England, concluded in 1966 when considering what to do about the sterling area system: 'we are a bank and have little option but to stay in business'.¹¹⁸⁵

What lessons does the sterling area have for reserve currencies today? Clearly, the unique institutional context and somewhat artificial underpinnings demonstrate that sterling's historic experience in the age of exchange controls is not relevant for predicting the dollar's future in the age of globalisation. The sterling area lacked the organisational depth and multilateral co-operation of the EPU or the present day Eurozone. Its problem was external imbalances rather than the internal imbalances that have plagued the euro – and its ultimate failure a salutary lesson that imbalances must be addressed. But some international policymakers may find attractions in the subtle power of its mechanisms. It was an institution that seemed to perform best in conditions of conflict, scarcity or war. Who knows? Both rising and declining reserve currency issuers may seek advantage in building similar, informal, rule-based financial alliances, as they struggle for supremacy in the twenty-first century.

¹¹⁸⁵ BOE:OV44/33, 'Working party...', Note to Rootham, summarises Fforde's views, 13/10/1966

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